United States General Accounting Office

GAO

Report to the Honorable
J. Robert Kerrey and the Honorable
John C. Danforth, U.S. Senate

December 1994

DEFICIT REDUCTION

Experiences of Other Nations

19960122 039

GAO/AIMD-95-30

GAO

United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-259538

December 13, 1994

The Honorable J. Robert Kerrey
United States Senate

The Honorable John C. Danforth
United States Senate

As you requested, this report reviews the deficit reduction experiences of six nations—Australia, Canada, Germany, Japan, Mexico, and the United Kingdom. We identified the elements prompting these governments to engage in fiscal austerity policies, what budget actions they took, and how they achieved political agreement to take these actions.

All six countries took actions to control spending, although few programs were eliminated. Revenue growth also contributed significantly, but was generally attributable to tax systems' response to economic growth and inflation. Through these measures, five of the six countries reached fiscal balance or surplus; Canada made progress to reduce its deficit without eliminating it. Despite such progress, all but Mexico reported deficits in 1993. These experiences show that significant structural improvement in fiscal policy is possible in modern democracies, although such progress is difficult to sustain.

This report was prepared under the direction of Paul L. Posner, Director of Budget Issues, who may be reached at (202)512-9573 if there are any questions.

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

Executive Summary

Purpose

During the 1980s, several industrial nations took action to eliminate their deficits. As requested by Senator Kerrey, who was subsequently joined by Senator Danforth, GAO reviewed the experiences of five nations that reached fiscal balance or surplus—specifically, Australia, Germany, Japan, Mexico, and the United Kingdom. GAO was also asked to examine the experience of Canada, a nation that, like the United States, has made some progress to reduce its deficit without eliminating it. Specifically, GAO was asked to identify what prompted these nations to engage in a policy of fiscal austerity, what budget actions they took to reduce their deficits, how they achieved political agreement to take these measures, and what could be learned from these nations' experiences that might be applicable to the United States.

Background

The President and the Congress have periodically acted to rein in large deficits, and the deficit has been reduced from a high of 6.3 percent of gross domestic product (GDP) in fiscal year 1983 to 3.0 percent in fiscal year 1994. The Congressional Budget Office (CBO) projects further shrinkage to 2.3 percent of GDP in fiscal year 1995. Although clear, near-term progress has been made, the long-term deficit problem remains. CBO figures suggest that if no further action is taken, the deficit will resume its upward path after 1998, to 3.6 percent of GDP in 2004, the last year for which a CBO projection is available. Growing health care costs, the baby boom generation's eventual retirement, and rising federal interest payments will continue to exert upward pressure on the deficit well into the 21st century.

An earlier GAO report[1] noted that a higher rate of private investment would support a more robust economy that will better enable the relatively smaller cohort of workers to finance the needs of large numbers of retirees. The surest way for the federal government to increase long-term economic investment and growth is to increase national savings by reducing or eliminating the deficit.

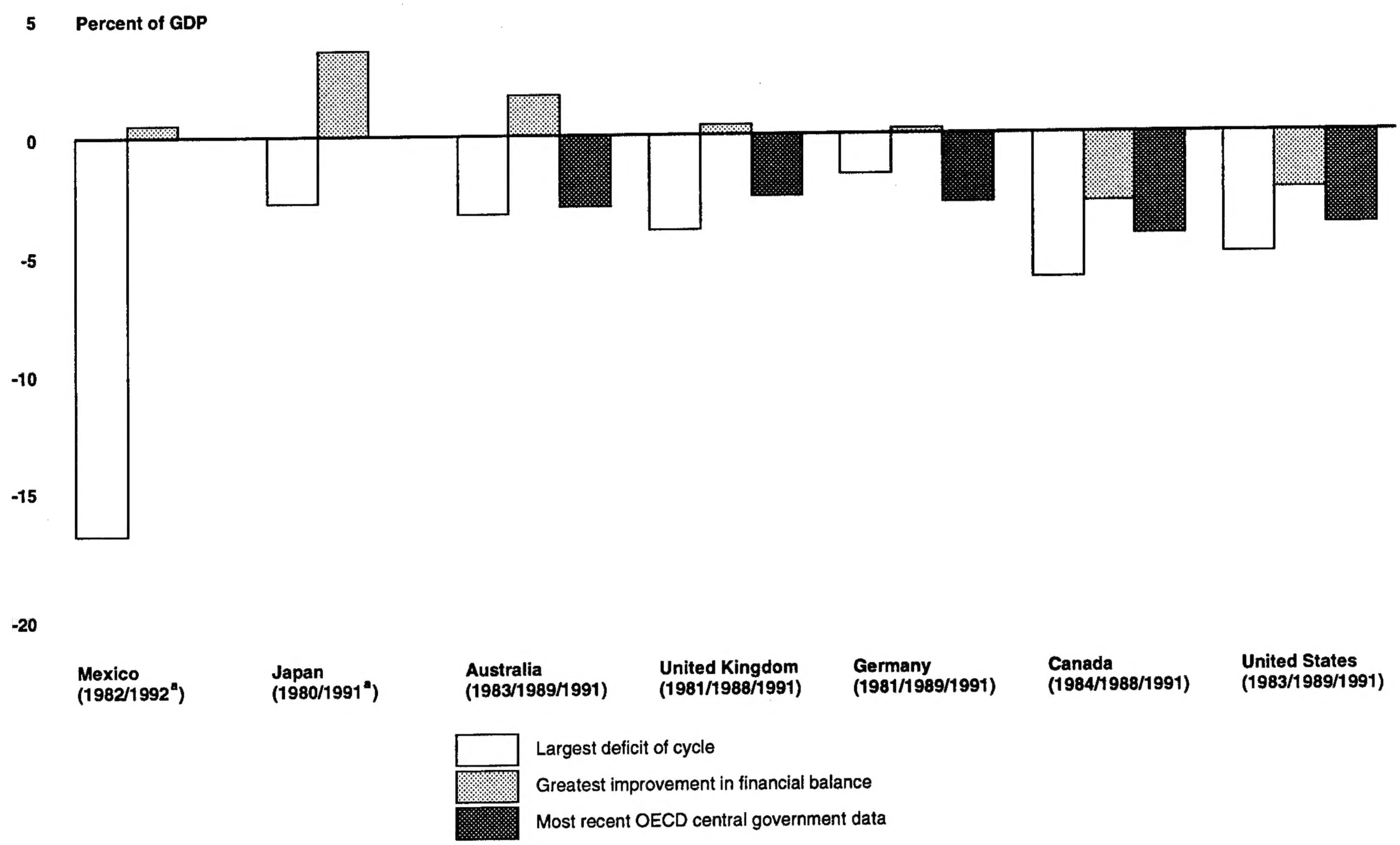
Although large deficits of the kind projected for the future in this country pose distinct fiscal and economic problems, it is generally acknowledged that it is very difficult for democratic nations to reduce or eliminate these fiscal imbalances. Some believe that deficits persist because the benefits of budget balance are long-range or economywide, while the short-term measures taken to achieve balance may generate controversy and have

[1]Budget Policy: Prompt Action Necessary to Avert Long-Term Damage to the Economy (GAO/OCG-92-2, June 5, 1992).

immediate impact. This situation has led some to believe that democracies will only deal with deficits when forced to do so by external credit markets or by constitutional or other legal requirements. They argue that, in the absence of these constraints, elected leaders cannot be expected to act due to the perceived political risks.

Australia, Germany, Japan, Mexico, and the United Kingdom moved from fiscal deficits as high as 16.9 percent of GDP to balance or surplus in the 1980s or early 1990s (see figure 1). Yet, four of these countries have slipped back into deficit, although cyclical economic changes account for at least part of the return to deficit.

Figure 1: Reducing Deficits: Shifts in Central Government Financial Balances



[a]For both Mexico and Japan, the most recent central government data available also represent the greatest improvement in financial balance. OECD general government data, however, suggest that deficits returned in 1994 in Japan.

Note: All data are for central governments, except Mexico, which is based on all levels of government. Data include social security trust funds.

Source: OECD National Accounts, Volume II, and the Banco de Mexico.

Results in Brief

The nations in this study instituted often painful measures to reach fiscal balance or surplus while generating and maintaining political support. Control of spending was the dominant policy tool used to achieve these goals, although few programs were eliminated. Revenue growth also contributed significantly to deficit reduction efforts in some countries but

was generally attributable to the response of nonindexed tax systems to economic growth and inflation. Tax reform undertaken in the six countries was largely revenue neutral, as governments sought to protect their revenue bases by combining tax cuts in one area with revenue increases in another.

Various factors prompted governments to adopt deficit reduction strategies. Of the six governments studied, only Mexico was forced to take deficit reduction measures as a consequence of economic crisis and the reaction of external credit markets. In all others, leaders defined the turning point in fiscal policy rather than waiting for a financial crisis to trigger decisions. Some reacted in part to fears of eventual negative external market reaction, but all drew upon internal economic concerns such as inflation and interest rates. Leaders used these themes to create a sense of urgency for reducing the deficit.

Effective consensus-building was essential to creating public support crucial to successful fiscal change. Governments brought key groups into the decision-making process, devising austerity strategies that helped promote support and reduce potential political opposition. Trading large cuts in one program for improvements in other ones, targeting cuts to higher-income beneficiaries, pursuing "shared sacrifice" strategies, and phasing in reductions over time all helped to reduce the impact of cuts on current beneficiaries. As the result of many factors and despite painful fiscal measures, governments successfully eliminating deficits were returned to office, in some cases several times.

The experiences of the case study countries show that significant structural improvement in fiscal policy is possible in modern democracies, although such progress appears difficult to sustain. Despite obvious cultural, political, and economic differences, GAO believes that elements of other nations' experiences may be of interest to the United States as it addresses this common challenge.

GAO's Analysis

Fiscal Actions Focused on Spending Cuts

Case study governments controlled the overall growth in spending such that year-to-year spending growth generally declined during the 1980s.

Figure 2 summarizes the spending actions governments took to reduce their budget deficits.

Figure 2: Contribution of Spending Actions to Deficit Reduction

	Set overall limits or goals	Cut public sector employment or real wages	Modified social benefits	Reduced payments to other levels of government	Cut capital spending
Australia	◒	◒	●	●	●
Canada	◒	◒	◒	●	◒
Germany	●	●	●	○	●
Japan	●	◒	◒	○	○[a]
Mexico	◒	●	◒	○	●
United Kingdom	●	●	◒	○	●

Legend
● Major action
◒ Action taken, but to lesser degree
○ No significant action taken

[a]Although the central government reduced capital spending, spending by local governments and the Fiscal Investment and Loan Program (FILP), a national investment program, made up the difference.

All six governments departed from previous budgeting approaches and imposed a "top-down" overall limit on government spending. The type varied, ranging from limits on total budgetary spending in the United Kingdom and Canada, to ceilings on growth in Japan, to broad fiscal goals in Germany, Australia, and Mexico. Despite this variation, each represented a multi-year approach that sought to reduce real overall spending.

Controlling spending meant restraining social benefit commitments in several countries. Some permanently changed the linkage between program benefits and inflation or suspended or delayed indexing for short periods of time. In other countries, spending for social benefits was restrained by eliminating the universality of certain benefits. For example,

in the 1980s, Australia limited the eligibility of its highest income groups for its pension and family allowance programs.

Strategies involving capital spending cuts and cost shifting to lower levels of government were also used. Reductions in capital spending occurred in most countries, both as a result of this cost shifting and directly at the central government level. Australia and Canada significantly reduced aid to their states and provinces, respectively, and thereby shifted downward both some fiscal stress and some of the difficult budget decisions.

Streamlining government and making the public sector more efficient were consistent themes across all the case study countries. Public sector employment was reduced; wage growth was slowed or wages frozen. In the United Kingdom, the cut was dramatic: the number of public sector employees was reduced by 26 percent between 1980 and 1992, partly reflecting privatization.

Privatization—shifting ownership from government to the private sector—of previously public functions contributed to spending reduction by removing subsidized activities from public budgets, while in many instances also providing one-time revenue from sale of the assets. Case study countries, however, privatized primarily to reduce the role of the public sector in the economy and to make the remaining public sector more efficient. The United Kingdom and Mexico were able to use this strategy to the greatest extent, principally because these two countries had large nationalized industries at the beginning of the 1980s.

Revenue Also Increased

Although few governments used tax legislation as a direct deficit reduction strategy, revenue growth nonetheless contributed substantially to achieving that fiscal goal. Strong economic growth in the mid-to-late 1980s increased tax revenues in several countries. Furthermore, tax systems that were not automatically indexed afforded governments the ability to retain revenue resulting from inflation, a phenomenon often referred to as "bracket creep." As a result, the combination of economic growth and inflation permitted these governments to reap large tax revenue gains "automatically."

Most of the countries GAO studied enacted some form of tax reform during the 1980s. Although governments did not rely on such reform for deficit reduction, they did attempt to structure tax changes to avoid revenue loss in both the short and longer term. In general, tax reform included some

combination of reducing top tax rates, reducing tax expenditures (exemptions and exclusions from the tax code), and increasing consumption taxes. Cuts in income tax rates were generally offset by revenue increases from other sources. In some countries, consumption tax increases were directly linked to offsetting income tax reductions. Such changes were not generally depicted as part of a government's deficit reduction strategy.

Leaders Helped Create Turning Points in Fiscal Policy

Only in Mexico did economic crisis and the external financial pressure of losing access to world credit markets prompt deficit reduction. Governments in some of these countries acted to reduce their future vulnerability to such events, while internal economic, cultural, or political pressures served as the impetus for leaders in other countries to embark on deficit reduction. Leaders often initiated action during economic downturns when deficits can increase and prompt concerns among credit and currency markets. Balanced budget requirements, present in Japan and Germany, neither prevented deficits nor triggered deficit reduction.

Most leaders defined the benefits of deficit reduction and the costs of doing nothing in sufficiently compelling terms to prompt action. Improving international competitiveness and long-run fiscal health, reducing inflation, stabilizing currency values, or reducing interest rates were elements of arguments for implementing what were at times painful austerity measures. Each government emphasized particular themes that appeared to resonate in that nation.

For example, Japan's culture places a high value on savings. Emerging concerns about debt levels and rising shares of the budget allocated to interest costs, and their effect on the government's ability to finance the nation's pension program in the long-term future, were important in driving the government to action.

Negotiations, Trade-offs, and Carefully Designed Cutback Strategies Fostered Support for Austerity

After making a compelling public case for deficit reduction, government leaders sought to gain support or at least defuse potential opposition by bringing key interest groups that would be affected into the decision-making process. In part, the governments' success in redefining the political climate and making deficit reduction appear inevitable helped bring these groups to the table. Mexico and Australia, for example, both involved key economic groups in the fiscal reform process, making fiscal sacrifice palatable in some cases by providing other policy concessions.

The specific strategies used to reduce the deficit also helped. Approaches such as reducing benefits instead of eliminating programs; targeting benefit cuts to higher income groups; and deferring, shifting, or obscuring painful adjustments all helped maintain political support for spending reductions. Some countries adopted long-term strategies that phased in cuts so they largely affected future beneficiaries. For example, the United Kingdom established a ceiling on home mortgage interest deductions at a time when most taxpayers' deductions were far below the ceiling; housing price inflation ultimately gave the ceiling real impact.

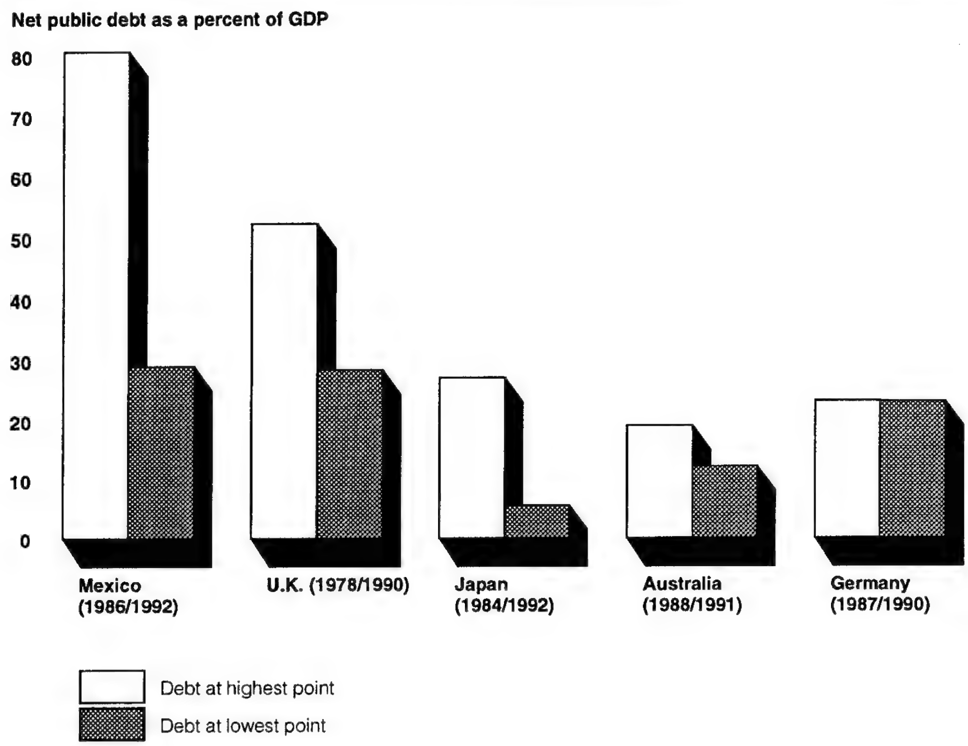
Deficit reduction nonetheless remained a political challenge. Governments were not always successful in eliminating or reducing opposition and on occasion had to withdraw deficit reduction proposals. Moreover, such pressures affected governments' abilities to sustain balance over the longer term. Yet, despite these reduction measures, governments in the five countries that balanced their budgets were re-elected, some several times. For example, the Australian Labor government took over in 1983 and was returned to office four times in the next decade, once only 2 months after announcing large expenditure cuts.

Fiscal and Economic Benefits of Austerity

Deficit reduction provided significant fiscal benefits by slowing or reversing the growth of public debt, thereby slowing or reversing the growth of government interest costs. What had once been a "vicious" circle of rising deficits, debt, and interest, which in turn can increase deficits, had become a "virtuous" circle of falling deficits or rising surpluses, declining debt and interest, and increased fiscal flexibility.

Figures 3 and 4 show the changes in debt and interest in the five countries that reached balance. Figure 3 shows the improvement in net debt balances in the five case study countries after deficit reduction. Figure 4 illustrates the improvement in the interest "bite"—interest payments as a percent of total expenditure—after deficit reduction.

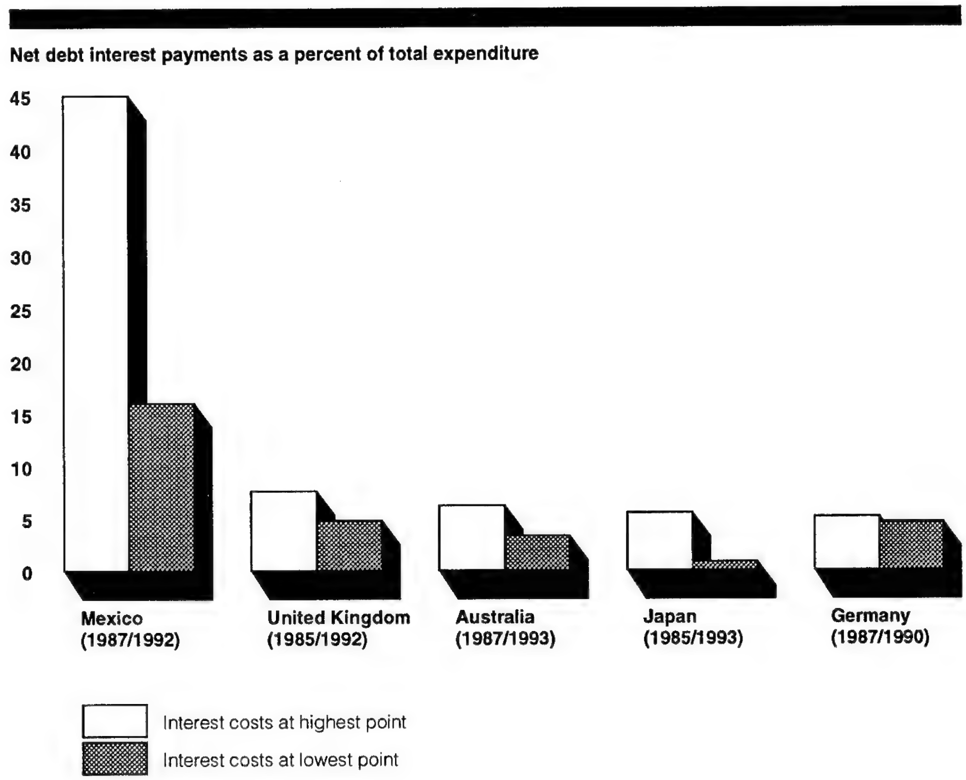
Figure 3: The Benefits of Deficit Reduction: Lowering Net Debt



Note: Mexico's 1992 data are preliminary.

Sources: OECD Economic Outlook, #55, and the Banco de Mexico.

Figure 4: The Benefits of Deficit Reduction: Lowering the "Interest Bite"



Sources: OECD Economic Outlook, #55, and the International Monetary Fund.

Economic benefits are longer term. The reduction of public debt can improve economic growth in the long run by freeing capital for private investment, a key element of long-term economic growth. Shorter-run effects can be contractionary for the economy, yet many of the case study governments reported economic improvements shortly after embarking on austerity policies. While other economic policies and events may have acted to offset the contractionary effects of deficit reduction, it is significant that leaders were able to strengthen support by pointing to positive short-run economic changes.

Nonetheless, sustaining support for fiscal balance or surplus was clearly difficult. Four of the five countries achieving balance or surplus have returned to budget deficits in the 1990s. These countries appear, however, better off fiscally and economically than if they had not reached balance.

The years of austerity left governments with lower debt levels than would otherwise have been accrued. Furthermore, the increases in savings and investment resulting from deficit reduction may have permanently boosted economic prospects—some economists believe that the countries should experience improvements in long-run living standards that would not have occurred otherwise.

Implications

The experiences of other nations provide insights that may help the United States address the long-term nature of its deficit problem, despite obvious political, cultural, and economic differences. Although progress has been made, the aging of the U.S. population and rising health care costs are projected to result in large future deficits.

The experiences of five of the nations indicate that eliminating deficits is possible in modern democracies and that leaders can succeed in mounting the case for prompt action before crisis ensues. Sustaining the sense of urgency and the fiscal balance over the longer term, however, is difficult. The experiences of these nations suggest that leaders are held accountable for social policy goals and other pent-up demands which become more compelling once fiscal balance or surplus is achieved.

This suggests that policymakers can strive to attain fiscal balance when presented with windows of opportunity, as defined by unique cultural and economic factors at work in each nation. Recognizing that such fiscal goals are difficult to both achieve and sustain, deficit reduction strategies could be designed to enhance the prospects for sustaining fiscal progress over the long run. Achieving sustainable fiscal progress can be enhanced by strategies that (1) address large and growing areas of the budget that drive deficits, (2) maintain focus on the structural deficit, which can be masked by short-term cyclical economic trends, and (3) exert positive long-term fiscal impact through deficit reduction measures that grow over time.

Contents

Tables

Figures

Abbreviations

ACTU	Australian Council of Trade Unions
CAP	Canadian Assistance Plan
CBO	Congressional Budget Office
CDU	Christian Democratic Union
CSU	Christian Social Union
CTB	Child Tax Benefit
CPP	Canada Pension Plan
EPAC	Economic Planning Advisory Council
EPF	Established Programs Financing
FDP	Free Democratic Party
FILP	Fiscal Investment and Loan Program
G-7	Group of Seven
GDP	gross domestic product
GNP	gross national product
GRH	Gramm-Rudman-Hollings
GST	Goods and Services Tax
IMF	International Monetary Fund
JNR	Japanese National Railways
LDP	Liberal Democratic Party
MOF	Ministry of Finance
NTT	Nippon Telegraph and Telephone
OAS	Old Age Security
OBRA	Omnibus Budget Reconciliation Act
OECD	Organization for Economic Cooperation and Development
PACTO	Pact of Economic Solidarity
PAN	National Action Party
PEMEX	Mexican Petroleum Company
PRI	Institutional Revolutionary Party
PSBR	Public Sector Borrowing Requirement
SERPS	State Earnings-Related Pension Scheme
SNA	System of National Accounts
SPD	Social Democratic Party
VAT	value added tax

Chapter 1

Introduction

During the 1980s and early 1990s, several advanced democracies eliminated large fiscal deficits. Starting from annual maximum deficits ranging from approximately 4 to 17 percent of gross domestic product (GDP), five of these nations reached public sector balance and, in several cases, even surplus. These achievements, remarkable for their difficulty, may provide insights to U.S. policymakers as they continue to address the federal budget deficit.

Senator Kerrey, who was subsequently joined by Senator Danforth, asked us to examine the deficit reduction experiences in five of the countries that achieved annual balance in the 1980s and early 1990s—Australia, Germany, Japan, Mexico, and the United Kingdom. We were also asked to study Canada, a country that, like the United States, has made progress to reduce its deficit but has not eliminated it.

Deficits and the Long-Term Economic Future

Deficits matter to all nations, regardless of the economy's size. Deficits matter in the long run because they consume private savings that otherwise would be available for private investment. In the absence of increased national saving, such deficits must be financed either by a reduction in private investment or by an influx of foreign capital. Because investment is essential to long-term economic growth, reductions in private investment levels threaten to reduce the growth of living standards. Reliance on foreign capital may maintain investment levels in the short run, but profits and interest payments will flow abroad in the future. Furthermore, should foreign investment decline, the nation could face increased interest rates as the reduced availability of capital raises its cost. Increasing national savings would increase the resources available for investment, and the surest way to increase national savings is to reduce budget deficits.

Deficits also matter in the shorter run because they reduce budget flexibility. Large deficits can cause public debt to grow faster than the economy, and may increase interest costs as a proportion of GDP, which would help drive deficits further upward. The continued growth of interest costs squeezes funds available to finance other priorities, limiting the government's flexibility to respond to new or emerging needs.

In the United States, the federal government has a recent history of chronic budget deficits. During the 1950s, the federal deficit averaged less than 1 percent of GDP, but by the 1970s the average rose to 2.2 percent. The

highest deficits occurred during the 1980s. The federal budget deficit peaked at 6.3 percent in 1983, and fell back to 4.0 percent by 1990.

The Congress and the President acted to reduce the deficit further through the Budget Reconciliation Acts of 1990 and 1993. By imposing caps on discretionary spending and maintaining restraints on expansion of entitlements and tax benefits, the legislation has cut hundreds of billions of dollars from the deficit's expected levels in the 1990s and in the longer-term future. In part as a result of these actions, the deficit dropped to 3.0 percent of GDP in 1994 and the Congressional Budget Office (CBO) projects further shrinkage to 2.3 percent of GDP in 1995.

Although clear, near-term progress has been made, the long-term deficit problem remains. CBO figures suggest that, if no further action is taken, the deficit will once again resume its upward path after 1998, rising to 3.6 percent of GDP by 2004, the last year of the CBO forecast available at this time. Debt held by the public—that part of the gross federal debt held outside of the federal government—is expected to grow from approximately 51 percent of GDP to 56 percent over the period. Growing health care costs, the baby boom generation's eventual retirement, and rising federal interest payments will continue to exert upward pressure into the 21st century. As we suggested in an earlier report,[1] a different fiscal policy path would help prepare for the nation's economic and demographic future.

Because deficit reduction represents one of the most pressing, yet most difficult, policy issues facing the United States over the long term, exploring the extent to which other governments have overcome comparable problems and ways they succeeded may provide insights to policymakers in the United States.

Deficits and the Policy-making Process

Although large deficits pose distinct fiscal and economic problems, most would acknowledge the difficulty of democratic nations' reducing or eliminating these fiscal imbalances. Some believe that deficits persist because the public perceives the benefits of achieving budget balance to be less compelling than the costs. The prospective benefits of such prudent fiscal policy—lower real interest rates, a larger pool of domestic savings to finance productive investment and, ultimately, improved prospects for living standards in the future—are long-range and

[1] Budget Policy: Prompt Action Necessary to Avert Long-Term Damage to the Economy (GAO/OCG-92-2, June 15, 1992).

economywide. Decisionmakers and the electorate must balance these against the immediate and concentrated cost of expenditure cuts, increased taxes, and reductions in public services and government transfers. Actions taken to achieve balance can therefore prove politically hazardous because groups losing benefits can be readily mobilized against cutbacks, while members of the general public who will eventually benefit through long-term economic improvement only weakly perceive these advantages.

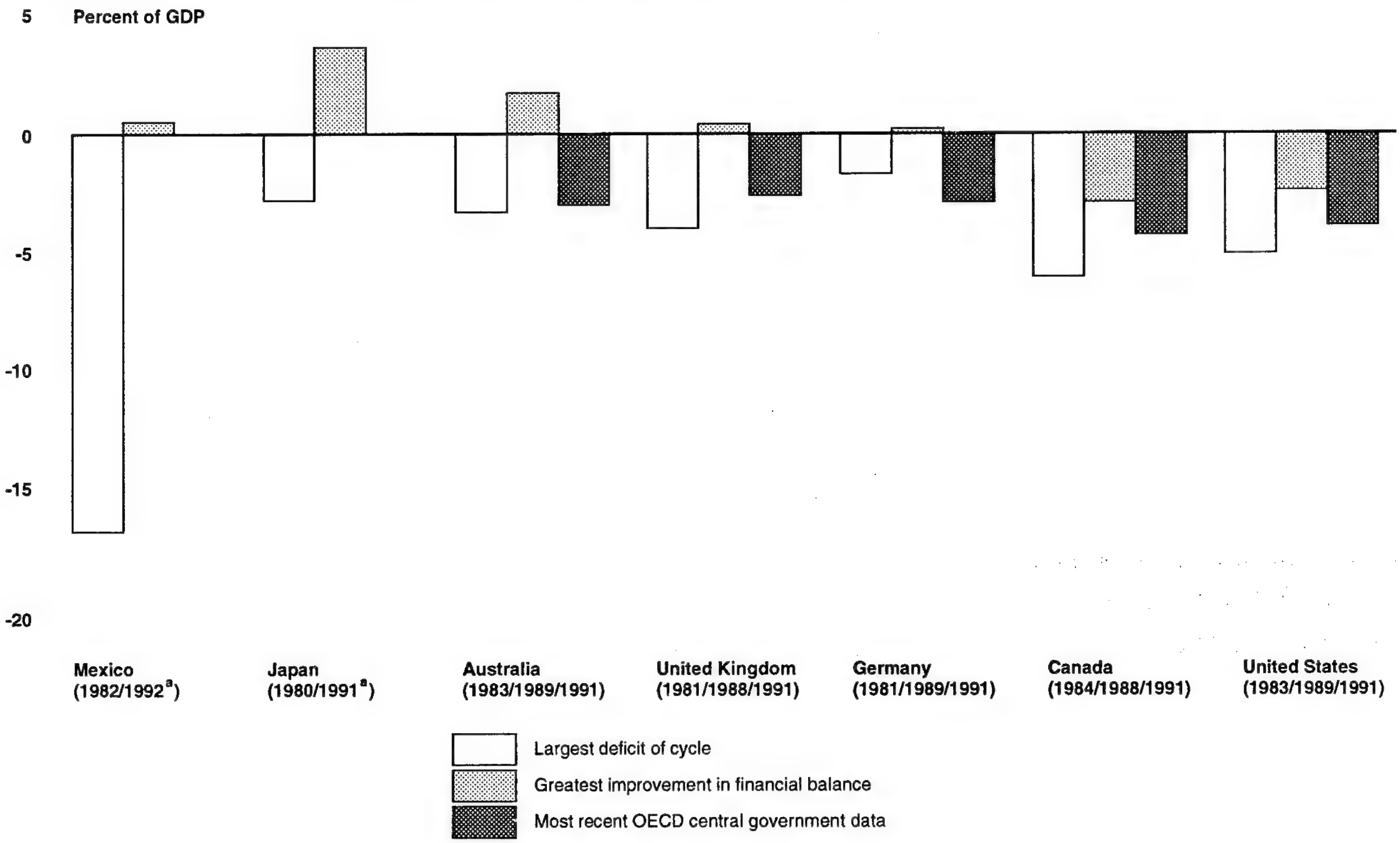
As a result, some commentators believe that democratically elected leaders cannot be expected to embark on meaningful austerity policies without an economic crisis characterized by pressures from external financial markets or constitutional or other legal requirements for fiscal balance. They argue that, in the absence of these constraints, leaders cannot be expected to act due to the perceived political risks. The attainment of fiscal balance in the advanced democratic countries we studied challenges these views.

Characteristics of the Six Countries

Figure 1.1 illustrates the largest annual deficits and surpluses at the central level in the case study countries and the United States. Social security trust funds are included. Mexico overcame the largest fiscal deficit: in 1982, Mexico reported a general government deficit of 16.9 percent of GDP and by 1992 reported a surplus.[2] Japan maintained surplus for the longest period, from 1987 to 1991, as measured by the Organization for Economic Cooperation and Development (OECD). Canada and the United States have both reduced their deficits but have not yet eliminated them.

[2]Mexico's balances represent those of all levels of government. Central government data are not available and subnational governments control a relatively small portion of public sector revenue.

Figure 1.1: Reducing Deficits: Shifts in Central Government Financial Balances



[a]For both Mexico and Japan, the most recent central government data available also represent the greatest improvement in financial balance. OECD general government data, however, suggest that deficits returned in 1994 in Japan.

Note: All data are for central governments, except Mexico, which is based on all levels of government. Data include social security trust funds.

Sources: OECD National Accounts, Volume II, and the Banco de Mexico.

An examination of more recent fiscal history in the six countries reveals that, based on projections, only Mexico remains in fiscal surplus. The United Kingdom underwent the greatest fiscal slide, reaching a deficit of close to 8 percent of GDP by 1993, after having attained a surplus in 1988 and 1989. The return to deficit in these countries suggests the difficulty of sustaining fiscal progress.

Isolating the structural fiscal balance from cyclical influences alters the fiscal picture somewhat.[3] Knowing how much of the deficit is structural and how much is cyclical can be crucial in measuring the degree of fiscal distress. Cyclical deficits, by their nature, decline as an economy improves and increase when an economy slips into recession because of the sensitivity of revenue and certain spending programs to the economy. Structural deficits require more fundamental change to be increased or decreased. If the economy is growing stronger, an improvement in the cyclical deficit could mask continuing structural problems. Conversely, if the economy is weakening, the cyclical deficit will grow, making the overall deficit appear larger and more urgent than may be the case over the long run. Hence some estimate of the cyclical vs. structural contributions to a fiscal deficit may help leaders determine the most effective fiscal policy.

In general, economic conditions exaggerated the extent of the case study countries' deficits at their "troughs," as well as the extent of improvement at the countries' fiscal peaks. Similarly, the recent slide back to deficit, in most instances, reflects cyclical change more than structural backsliding. The United Kingdom is projected to have the largest negative structural deficit, while Japan's figures suggest that its projected deficit is entirely due to economic downturn.

Demographic and Economic Differences

The countries selected for case studies varied in size, in type of government, and in the public sector's role (see table 1.1). Japan has both the largest population and economy of the group, although substantially smaller than those of the United States. GDP in Japan and Germany ranks below only the United States among all OECD countries. Mexico is the second largest of the six case study countries in population, but ranks second to last in terms of GDP. Australia is the smallest of the six countries in terms of both population and GDP.

[3]Deficits in many countries are highly responsive to economic conditions. During times of slow or negative growth, lower incomes and employment cause tax revenues to fall and spending for social programs to rise. This automatic rise in the deficit is cyclical. The structural deficit measures discretionary fiscal policy and other noncyclical factors affecting the budget.

Table 1.1: Characteristics of the Six Case Study Countries and the United States, 1991

	Population (in thousands)	GDP (in billions $ US)	Public sector outlays (% GDP)	System of government
Australia	17,292	280.0	36.6	Parliamentary/ federal
Canada	27,000	520.6	47.9	Parliamentary/ federal
Germany	63,889	1,257.8	44.2	Parliamentary/ federal
Japan	123,920	2,349.2	25.4	Parliamentary/ unitary
Mexico	81,250 (1990)	329.0 (1992)	26.9	Presidential/ federal
United Kingdom	57,649	899.8	39.7	Parliamentary/ unitary
United States	252,160	5,610.8	36.7	Presidential/ federal

Five of the six case study countries have parliamentary systems of government. Mexico, the exception, has a presidential system. The five parliamentary systems differ in the relative power awarded the upper houses of parliament, the power of the ruling party, and the roles of public interest groups. The relationships between the central governments and the subnational governments also vary considerably.

More detailed information on each of the six countries, their political systems, their budget structures, and their fiscal policies is provided in appendixes I-VI.

Definitions of Balance

Countries' definitions of fiscal balance vary depending in part upon tradition, relationships with subnational governments, and budget structure. Mexico and the United Kingdom consider the entire public sector borrowing requirement; Australia, Canada, and Germany focus on central, or federal, government activities; while Japan focuses even more narrowly on only part of the central government's fiscal activity. Specific definitions of balance, where dramatically different from OECD general or central government balances, are described in the country appendixes.

For purposes of comparability among countries, the most commonly used standardized measures of fiscal deficits and surpluses are those for all levels of government, or general governments, reported by the OECD from the United Nation's System of National Accounts (SNA). However, fiscal

deficits for all general governments may not be exact proxies for budget deficits as they are perceived in a particular country. In the case of a country with a unitary governmental system, such as the United Kingdom, the deficit or surplus (the public sector borrowing requirement) represents borrowing at all levels of government. However, in some federal systems, such as Australia, Canada, and Germany, the fiscal policy at the federal level may be perceived as largely separate from the fiscal policy at the state or local levels. Governments in this case may focus primarily on deficits at the federal level.

Moreover, Japan has large off-budget accounts for pensions and investment. In this case, political debate over fiscal policy can use data that substantially differ from those in the official SNA accounts. We used the definition each nation used in its fiscal policy debate, where appropriate, when analyzing deficit reduction in the case study countries, in recognition that a government's own measures are the most relevant in understanding the actions considered. To compare across nations, we used OECD data and definitions. As Mexico only joined the OECD in 1994, OECD data were not available. Data for Mexico were derived primarily from the Banco de Mexico, Mexico's central bank. We did not independently verify either OECD, Banco de Mexico, or national data.

Objectives, Scope, and Methodology

Senators Kerrey and Danforth asked us to review the deficit reduction experiences of Australia, Canada, Germany, Japan, Mexico, and the United Kingdom. Specifically, they asked us to identify what prompted these nations to engage in a policy of fiscal austerity, what budget actions they took to reduce their deficits, how they achieved political agreement to take these measures, and what could be learned from these nations' experiences that might be applicable to the United States.

To accomplish these objectives, we reviewed OECD and International Monetary Fund (IMF) data on the case study countries' fiscal deficits, and in each country we interviewed officials and analysts familiar with their government's actions. We also interviewed and obtained documentation from government officials to better understand not only what deficit reduction took place, but how the countries' deficit reduction strategies were formulated and implemented. We also interviewed and obtained data and information from OECD officials, public policy critics, academicians, journalists, and members of the main political opposition parties in the case study countries to obtain their views. We reviewed a wide array of

reports and economic analyses on deficit reduction in general and in the specific case study countries.

We have presented the most significant deficit reduction actions, including those that produced large savings or revenues, as well as those that were significant for political or economic reasons. While this report cannot fully detail all of the economic policies of the case studies countries in the 1970s and 1980s, we outlined elements of the economic situation and policies which most help to explain how the countries reduced their deficits.

Our work was conducted in the six case study countries and Washington, D.C., from May 1993 through August 1994 in accordance with generally accepted government auditing standards. Experts on each country's fiscal and economic policy reviewed each of the case study summaries, and experts in comparative public policy reviewed our analysis and findings. The reviewers generally agreed with our work, and we have incorporated their comments where appropriate.

Chapter 2

Leaders Defined the Turning Point in Fiscal Policy

While deficits experienced by governments in all six countries had similar causes, the elements triggering government response to those deficits varied. Only in Mexico did real economic crisis precipitate deficit reduction. A variety of economic, political, and cultural pressures, none of them barring the government from financing its needs in the near term, led to the fiscal turning point in the other five countries. Political leaders in the case study countries often succeeded in defining these pressures as a crisis warranting fiscal sacrifice, at times even displacing other political or economic goals to pursue deficit reduction.

Deficits in All Six Countries Had Similar Roots

Officials in the six case study countries pointed to many of the same elements leading to deficits in the 1980s: broadened public sector commitments in the 1960s and 1970s, slowed economic growth, and fiscal and economic reaction to rapidly changing oil prices. The causes were interdependent and the effect of each cannot easily be isolated, but together they were responsible for large public sector deficits.

Program Expansion Helped Create Fiscal Imbalance When Economies Changed

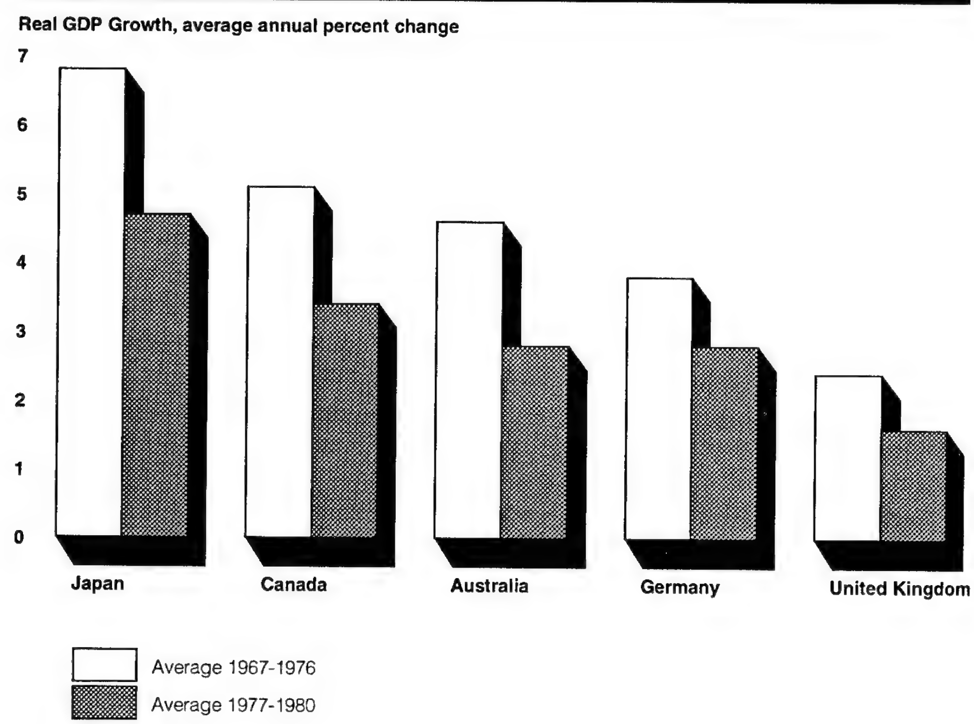
The fiscal deficits of the 1980s were rooted in decisions made in the 1960s and 1970s to create and enlarge public programs. Governments in most of the case study countries increased spending under the presumption that the high economic growth rates of the 1950s and 1960s would continue. By the time economic growth rates slowed in the mid-1970s, many of these programs were entrenched.

In most of the countries, these programmatic expansions involved social welfare commitments. In Canada, for example, the government had developed a strong social welfare system since World War II, and in the mid-1970s, it began fully indexing benefits for inflation. The government in the United Kingdom also offered new benefits and expanded existing ones. In 1971, the government introduced the Family Income Supplement, a new means-tested benefit, and then raised the benefit periodically; a One Parent Benefit was added in the late 1970s. Similar social welfare expansion occurred in Germany and Australia. Spending for many of these programs expanded during times of economic stress or slower economic growth and thus had a stabilizing or countercyclical effect. By expanding these commitments, and therefore the portion of the budget that reacts automatically to cyclical movements in the economy, public budgets became more vulnerable to economic swings.

Economic Slowdown and Oil Price Shocks Contributed

All of the case study countries except Mexico experienced recession or significantly slower economic growth in the 1970s. As shown in figure 2.1, Japan, Canada, and Australia all experienced sizable reductions in their average real GDP growth rates. Japan, for example, averaged 10.9 percent real growth from 1960 to 1973, but dropped to 3.6 percent from 1974 to 1980. Such reduced growth resulted in lower than anticipated revenue collections and increased demand for social welfare spending, thereby creating or adding to governments' budget deficits.

Figure 2.1: Real GDP Growth Comparison



Note: Comparable data for Mexico were not available.

Source: OECD Economic Outlook, #55.

Initially, some governments seemed to view these changes as temporary, that is, as part of the normal business cycle, and thus made few substantial fiscal adjustments. Projections of government revenue and expenditure,

and therefore deficits, assumed a continuation of or return to the higher growth rates of the past. These optimistic projections exacerbated the fiscal problem because the economic slowdown of the early and mid-1970s in fact represented a longer term decline in real growth rates. When the expected levels of economic growth did not materialize, the governments found themselves overcommitted and facing even larger deficits.

International economic policies may also have contributed to deficits. Officials in Germany and Japan noted that the Group of Seven (G-7)[1] asked Japan, Germany, and the United States to follow fiscal stimulus policies to stimulate worldwide economic growth. As a response to this "locomotive theory" that the 3 largest economies could provide the engines for growth in other industrialized economies, Germany and Japan increased public spending.

In all but one of the countries we visited, officials reported that the sudden increases in oil prices in the 1970s, in combination with other domestic and foreign events, precipitated the slowdown in economic growth. The economies of these five oil-dependent countries struggled to absorb the shock of higher prices. Even the United Kingdom, which eventually reaped benefits from its oil reserves, experienced the same dampening economic and fiscal effects initially. Only Mexico, an oil-exporting country in the 1970s, benefited initially from the price hike; however, Mexico became dependent on its new-found wealth to finance public sector expansion and, ultimately, the volatility of oil prices contributed to Mexico's economic crisis.

The shock to growth patterns in these countries proved profound. Japan, the United Kingdom, Canada, Germany, and Australia reported continuous large fiscal deficits after the mid-1970s; Mexico embarked on spending levels that proved unsustainable when oil prices fell in the 1980s.

Pressure, Not Crisis, Precipitated Action in Five of the Six Countries

Some observers suggest that governments dependent on popular support will undertake fiscal sacrifice only when it is clear that they have no alternative. According to this line of thought, only when financial markets refuse to continue financing a government's deficits will leaders be able to effectively mobilize public support for spending cuts or tax increases.

Yet, of the six deficit-reducing countries we studied, only Mexico faced this type of profound economic crisis—a loss of access to credit

[1]The G-7 includes Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

compounded by triple-digit inflation. Governments in some of these countries acted to reduce their future vulnerability to such events, while internal economic, cultural, or political pressures served as the impetus for leaders in other countries to embark on deficit reduction.

Only Mexico Lost Access to Credit Markets

Although Mexico experienced some of the same factors that brought about other countries' deficits, Mexico's vulnerability to the combination of volatile oil prices and heavy reliance on debt for public sector financing ultimately resulted in the government's inability to borrow, which in turn ensured that deficit reduction would become a high public priority.

Mexico actually faced two distinct economic crises during the 1980s, when deficits exceeded 16 percent of GDP. The first, in 1982, came about because the Mexican government was relying increasingly on international borrowing to support the deficit. Mexico's public external debt jumped from about $34 billion in 1980 to over $63 billion in 1983, higher than other developing borrowers such as Brazil or Venezuela. When it could no longer obtain foreign financing, the government was forced to adopt immediate deficit reduction measures. Although the deficit was indeed reduced briefly, the measures taken were largely temporary and by 1986 the deficit was again 16 percent of GDP. Faced with triple-digit inflation, mounting debt and interest payments, and the continuing threat of again losing access to credit markets, the Mexican government adopted long-term, structural fiscal policy changes. Officials in Mexico told us they had little choice.

Other Countries Faced Economic, Fiscal, and Political Pressures

A variety of pressures influenced the governments in the other five countries to take fiscal action. Of these, economic pressures such as rising inflation or falling terms of trade consistently played a leading role in defining the need for deficit reduction. At different stages and to different degrees, governments and the general public became convinced that a stronger fiscal position would improve each country's economic stability.

For each country, the factors that represent economic stability are different. Only Mexico faced an immediate crisis, but some others feared that failure to address these economic pressures would prompt an international crisis of confidence either in the near or long term. Governments in countries which relied heavily on trade were particularly vulnerable to external pressures such as depreciating currencies. For example, the Australian government used collapsing export prices, falling

currency values, and the fear that Australian's long-term standard of living was threatened as justification for embracing strong fiscal restraint in the latter half of the 1980s. Rising inflation—whether it was triple-digit inflation in Mexico, double-digit inflation in the United Kingdom, or single-digit inflation in Germany—was a consistent theme across the six countries.

Fiscal pressures, such as the level of debt and the related problem of ballooning interest costs, also raised public concern. In Japan, rising public debt and the expanding use of resources for interest payments brought into question the government's ability to finance the nation's pension program in the long term. Based on an international comparison, gross debt in Japan rose from around 12 percent of GDP in 1970 to over 50 percent of GDP in 1980. By 1983, interest payments in Japan had surpassed every other budgetary expenditure except social security in the general account budget. In Canada, the government felt similar pressures, particularly since a large portion of its public debt is foreign-held, and therefore may be subject to higher interest rates.

Several governments also faced pressures of a uniquely political nature—the Labor party in Australia provides the clearest example. According to a budget expert, a Labor government in the 1970s ushered in large deficits due to expanded spending initiatives; the government fell in 1975 when it lost a key budget vote in the Senate. When the Labor party was returned to power in 1983, many in the party believed they had to overcome a negative fiscal legacy held over from the 1975 Labor government. Accordingly, they were receptive to offering deficit reduction strategies when faced with economic pressures.

Historical or cultural traditions seemed to magnify the economic and fiscal pressures felt by these governments. This proved particularly true in Japan and Germany. Japan's culture places a high value on savings in preparation for future needs. This tradition accentuated the fiscal pressure of high debt and interest costs. In Germany, fear of inflation stemming from the period of hyperinflation earlier in the century made 6 percent inflation a cause for public concern. Each of these countries responded to a threshold of concern that was unique and conditioned by their own situation.

Both of these nations had balanced budget requirements. In neither country did these requirements prevent deficits, nor did they force action once large deficits formed. In Japan, legislation stipulates that government

finance should be subject to the principle of a balanced budget, and the government may only issue bonds if the funds are used for public construction, capital contribution, or loans. However, this restriction did not effectively bar deficits. Beginning in 1975, the government each year passed a resolution allowing the issuance of deficit financing bonds to close the budget gap. The German balanced budget requirement stems from the national constitution. As in Japan, investment expenditures are exempt from the requirement. There can be exceptions to the balanced budget requirement, however, if deficits are deemed necessary to stabilize prices, maintain a high level of employment, and achieve steady economic growth.

Leaders Decided to Act

These pressures on the governments did not themselves force action. Political leaders responded with deficit reduction proposals, creating a significant turning point in each of their country's fiscal policy paths. It did not appear easy: fiscal austerity represented a sharp change from the government's preferred policy agenda in some countries; in many instances, fiscal contraction was initiated during adverse economic circumstances as well, with the accompanying political risk of increasing social unrest.

Governments Pursued Austerity Policies Despite Other Priorities

With the exception of Mexico, most of these governments could have chosen not to follow a deficit reduction path. Political leaders had several options to choose from, including allowing the deficit to worsen, trying to address their economic problems primarily through monetary policy, or addressing the deficit in a "muddling through" fashion, where some actions are taken but little permanent progress is made. Yet deficit reduction became a high priority as leaders believed that the potential political and economic benefits would outweigh the short-run sacrifice.

Conservative and liberal governments alike took on deficit reduction. Some governments receiving election mandates took action immediately upon assuming office. The best examples were the United Kingdom and Germany, where in 1979 and 1983, respectively, the conservative parties were elected on platforms that focused on fiscal restraint. Once in office, some governments found that deficit reduction superseded other economic or political goals. For example, the Australian Labor government had not initially campaigned for fiscal austerity nor was such policy emblematic of its political philosophy. However, once elected, this government, feeling the pressure of currency depreciation and convinced

that currency stability depended on deficit reduction, chose to adopt fiscal restraint. This choice is particularly significant given the fact that in Australia, fiscal restraint had previously been associated with the conservative opposition party.

Conservative governments, too, had to relinquish or defer other political goals when they chose to reduce the deficit. The Conservative government in the United Kingdom included deficit reduction as a fundamental party goal, but when deficits worsened, it had to defer promised tax reductions and other of its priorities until deficits were under control. The German government deferred income tax reductions for several years until its deficit was under control.

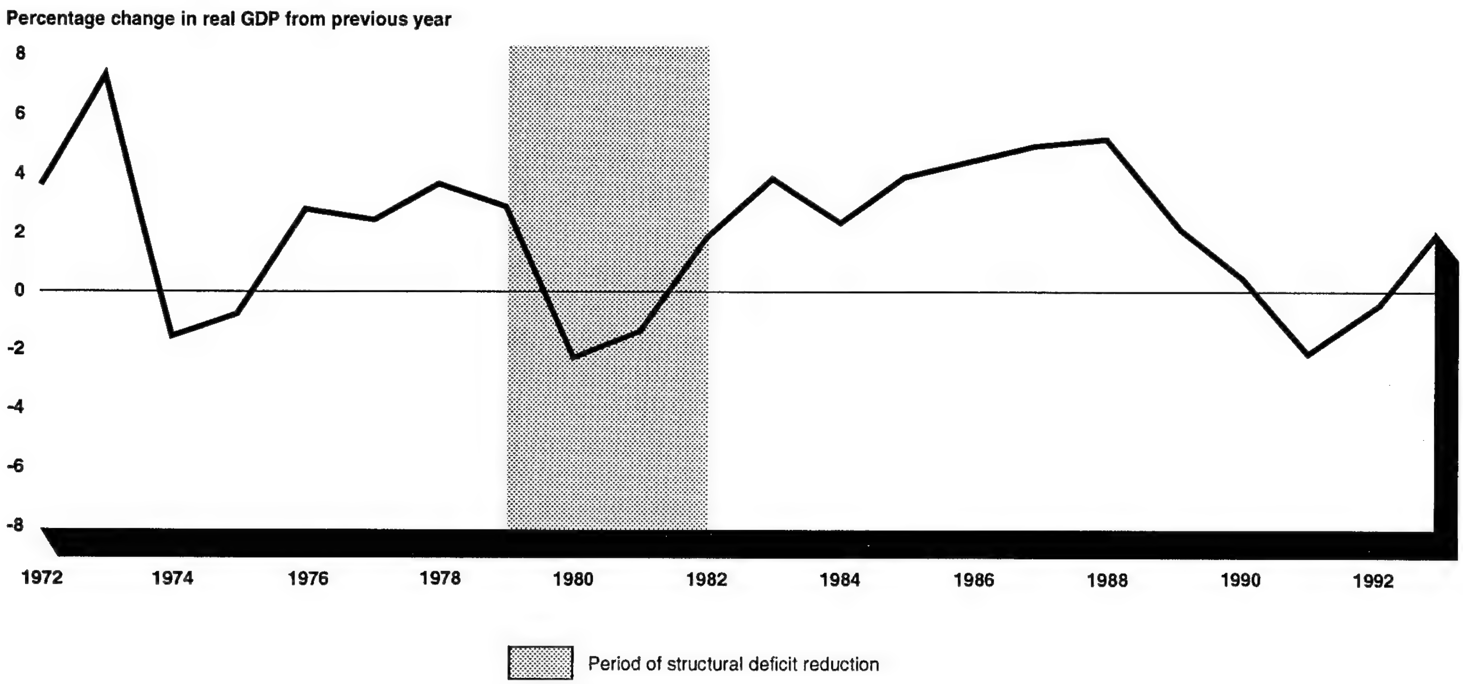
Leaders Acted During Economic Downturns

Most economists would not advise contractionary fiscal policies such as major deficit reduction during an economic downturn; if such policies are pursued, they need to be closely coordinated with an accommodative monetary policy to avoid weakening the economy. Conversely, such contractionary policy during times of robust economic growth can help to offset the buildup of inflationary pressures in the economy.

Contrary to this prescription, most governments began deficit reduction during periods of slow economic growth or recession. Budget deficits in advanced economies increase during economic downturns due to lower revenues and higher spending on countercyclical benefit programs. These higher deficits spark concerns by credit and currency markets that, if not addressed, could lead to further economic problems such as higher interest rates or falling currencies. From this perspective, deficit reduction takes on a particular urgency, which makes policy action seem necessary to ward off other economic problems. Higher deficits and the possibility of negative economic consequences helped leaders convince the public of the need for action.

In four of the countries, policymakers responded to these pressures by implementing deficit reduction during recessions or periods of slow economic growth. For example, as shown in figure 2.2, the United Kingdom pursued its deficit reduction program during a recession in order to stem inflation and high interest rates. This action sparked controversy; 364 economists in the United Kingdom wrote a letter to The Times (London) protesting the government's tight fiscal policies in the depths of a recession, stating that the policies would deepen the economic trough.

Figure 2.2: Deficit Reduction and Economic Growth in the United Kingdom, 1972-1993



Source: OECD Economic Outlook, #51 (1972-1976) and #55 (1977-1993).

Spending Actions and Economic Growth Combined to Reduce Deficits

Governments in the case study countries focused primarily on slowing spending growth to attack budget deficits. By slowing the growth of spending, these governments improved the structural balance between revenues and expenditures in their budgets. Governments that maintained austerity for several years after economic recovery was under way positioned themselves to maximize the benefits of cyclical improvements and thus make quick progress toward eliminating deficits and achieving budget surpluses.

Governments made significant tax changes in every country, but tax changes were largely instituted in a revenue-neutral manner that did not immediately contribute to deficit reduction. However, income tax rates in these countries are not automatically indexed to fully adjust for inflation; therefore inflation led to increased revenues and contributed to deficit reduction. Some countries also benefited from privatization and oil revenues. The governments most successful at reducing budget deficits made spending reductions appear purposeful and revenue increases largely automatic.

Governments in All Six Countries Took Action to Reduce Spending Growth

Governments in the case study countries addressed deficits by controlling the overall growth in spending. In general, growth in spending from year-to-year declined during the 1980s. (See table 3.1.) Overall spending targets were often used to ensure that spending growth was held below the growth in the economy.

Table 3.1: Public Sector Outlays as Percent of GDP—1982, 1986, and 1989

Country	1982	1986	1989
Australia	33.0	37.3	32.8
Canada	44.8	44.6	43.1
Germany	49.0	46.4	44.8
Japan	33.0	32.0	30.9
Mexico	44.5	44.9	34.2
United Kingdom	44.5	42.4	37.5

Although governments actively took steps to slow the growth of spending and reduce deficits, for the most part, these actions did not represent major changes in the roles and responsibilities of the central government. Generally, these governments eliminated few programs. Instead, they made spending cuts by reducing social benefits, payments to other levels of government, capital spending, and the number of government employees. In one area, privatization of government-owned enterprises,

governments did shift a portion of their responsibilities. However, while governments benefited from one-time increases in revenues and permanently reduced liabilities, privatization actions were taken primarily to reduce the government's overall involvement in the economy rather than to reduce the deficit.

Figure 3.1 summarizes the spending actions governments took to reduce their budget deficits.

Figure 3.1: Contribution of Spending Actions to Deficit Reduction

	Set overall limits or goals	Cut public sector employment or real wages	Modified social benefits	Reduced payments to other levels of government	Cut capital spending
Australia	◒	◒	●	●	●
Canada	◒	◒	◒	●	◒
Germany	●	●	●	○	●
Japan	●	◒	◒	○	○[a]
Mexico	◒	●	◒	○	●
United Kingdom	●	●	◒	○	●

Legend
● Major action
◒ Action taken, but to lesser degree
○ No significant action taken

[a]Although the central government reduced capital spending, spending by local governments and the Fiscal Investment and Loan Program (FILP), a national investment program, made up the difference.

Overall Limits Helped Control Spending

All case study governments used some form of spending limit or target to control aggregate spending. These overall targets were a departure from the budgeting approaches of the past in that they imposed "top-down" limits on central government spending.

There was wide variation in the nature of the spending limits. Governments in the United Kingdom and Canada imposed limits on total budgetary spending. The Japanese government froze or required negative growth in spending. The governments of Germany, Australia, and Mexico

used broad fiscal goals. Although the nature and effectiveness of these limits varied, each represented a multi-year approach that sought to reduce real overall spending and included consideration of both discretionary and mandatory programs.

In the United Kingdom, the government used spending targets to manage its budget and to ensure that overall spending did not exceed a ceiling. The current target covers most of the budget, excluding interest, the cyclical portion of social security programs, and privatization proceeds. The government attempts to stay within the targets, and if spending in one area grows faster than predicted, the government reduces spending in other areas to stay under the limit. For example, although social spending grew faster than other areas of the budget in the 1992 budget, the government had to cut other programs. As a result of the spending targets implemented over the decade, annual real growth in public expenditures in the United Kingdom averaged only 1.3 percent during the 1980s, representing a significant drop from 3.3 percent during the 1970s.

The Japanese government used spending limits extensively by freezing, and sometimes requiring decreasing levels of spending on a limited portion of central budget general expenditures. In 1982, the Japanese government imposed a "ceiling" that required a zero percent nominal increase in expenditures over the previous year's budget on expenditures subject to the ceilings. In 1984, the ceilings for the affected current expenditures were decreased by ten percent from the previous year's level, and the ceilings for relevant investment expenditures were decreased by five percent. Ceilings on current expenditures decreased ten percent annually throughout the rest of the 1980s and were still in place in 1993.

Other countries' governments used broad fiscal policy goals, rather than actual spending limits, to reduce spending. In Germany, the goal was to hold the growth in spending at all levels of government to not more than 3 percent each year during much of the 1980s. The Australian government had a goal of not allowing government expenditures to increase as a percentage of gross domestic product, but it applied strict limits only to the 10 percent of its budget associated with "running" or overhead costs and required federal agencies to reduce these costs each year from the 1987-88 budget in exchange for greater management flexibility.

The Canadian government established spending limits in 1992 which stated that non-interest spending through the 1995-96 budget, including

mandatory or entitlement spending, could not exceed levels projected in 1991. The legislation stipulated that if program expenditure rose above its projected level for economic or policy reasons, the increase had to be offset by reductions elsewhere in the budget. However, some experts questioned the effectiveness of these limits, stating that the ceilings were too high and did not force constraint. An expert suggested the spending limits may not be renewed by the new government following their expiration in the 1995-96 budget.

Figure 3.2: Spending Limits in the United States

Two approaches to reducing overall spending have been enacted since 1985. The Balanced Budget and Emergency Deficit Control Act of 1985, known as Gramm-Rudman-Hollings (GRH), attempted to eliminate the deficit by setting declining annual deficit targets. GRH provided for automatic, across-the-board spending reductions--sequestration--if the deficit targets were exceeded. However, the combination of special rules limiting application of a sequester to some programs, including Medicare, and exemptions for means-tested programs and Social Security meant that only about 40 percent of spending was subject to sequestration. As the sequesters that would be required grew larger, the law was changed, and in 1987, the targets were revised and extended. Despite GRH, the deficit reached a record level by 1990.

Passage of the Omnibus Budget Reconciliation Act of 1990 (OBRA) changed the focus of budget control from overall deficit levels to actions taken to affect taxes and spending. This law placed caps on discretionary spending controlled through appropriations and required new legislation that increases direct spending or cuts revenue to be deficit neutral. In 1993, the limits in the law were extended through fiscal year 1998. This framework, however, does not limit deficit increases from changes in entitlement spending or revenues that result from economic or technical changes.

Social Program Spending Was Restrained in Several Countries

Social program spending was restrained in several countries by changing the way benefits were adjusted for inflation and by reducing or eliminating benefits for upper income recipients. Although inflation adjustments sometimes produced only minimal short-term savings, they resulted in significant long-term savings. Eliminating the universality of some benefits permitted governments to realize savings and maintain or increase benefits to those in the greatest financial need.

After coming into power in 1983, the Australian Labor government reduced universality over the next several years in the areas of old age pensions, family allowances, and unemployment benefits. For example, the government re-established means-testing of old age pension benefits. In Australia, men become eligible for the old age pension at age 65 and women at age 60. Means-testing had been abolished in the mid-1970s. In November 1983, an income test was re-established, and, in March 1985, an assets test for all pensioners was restored. Only one test is applied—an individual's old age pension is the lower of the amount determined by the income or assets test. As a result of these changes, the percentage of seniors receiving old age pensions dropped from 86 percent in 1983 to 76 percent by 1991. Although the universality for the national old age pension system was reduced, the government later improved the private pension system covering Australian workers referred to as "superannuation."

The Australian government also realized budgetary savings in the second half of the 1980s by means-testing family allowances and unemployment benefits as a way to improve targeting. In announcing this change, the Australian Treasurer justified such changes with the following statement: "It is clearly not reasonable that the taxes of low and middle income families should continue to fund benefits for the relatively well-off."

Some changes in social benefits were designed with a long-term perspective to produce "wedge-shaped" budget savings—that is, savings from particular policy changes that start out small and grow in future years. In the United Kingdom, in 1979, the government changed the basis for calculating inflation adjustments for its national old age pensions and other social security benefits from the greater of wage or price increases to increases in prices. Although the long-term effects of this change may not have been apparent at the time, it slowed the growth in program spending because in the United Kingdom prices increased more slowly than wages. The government also limited the mortgage interest deduction by setting a nominal ceiling on the mortgage amount that qualifies for the

interest deduction, a change that brought in increasingly more tax revenues as housing price increases drove the value of more homes above the limit. The German government deferred indexation of pension benefits for 6 months in 1983 and cut unemployment benefits to recipients without children from 68 percent of their net wage to 63 percent in the 1984 budget. As of October 1994, the Japanese government was considering legislation raising the retirement age from 60 to 65 for its social security program beginning early in the next century, a step that will result in long-term savings.

Several governments took steps to reduce or control health care spending. The Australian government, after introducing universal health care in 1983, began reducing benefits as part of its deficit reduction steps in the 1986-87 budget. Over the next several budgets, health savings included reductions in medical, hospital, and pharmaceutical benefits. Germany, which has universal health insurance, moderated the growth in spending on physician care in the 1980s through budget controls.[1] Faced with new spending pressure, in addition to these controls, the German government initiated a 3-year emergency measure in 1993 to impose mandatory global budget limits on spending in the physician, hospital, dental services, and prescription drug sectors of its health care system.[2] Japan has also sought to moderate health care spending through nationwide controls on health care prices and budgets.

[1] Health Care Spending Control: The Experience of France, Germany, and Japan (GAO/HRD-92-9, November 15, 1991).

[2] 1993 German Health Reforms: New Cost Control Initiatives (GAO/HRD-93-103, July 7, 1993).

Figure 3.3: Targeting Entitlements

Governments in Australia and Canada reduced the universality of some program benefits in order to reduce budget deficits. In Australia, changes were made primarily on the spending side, while in Canada spending was modified and benefits were taxed. These actions were illustrative of two of the options outlined in a recent CBO report--denying benefits to high-income recipients and taxing benefits.

In the mid-1980s, the Australian government introduced means testing of pension, family, and unemployment benefits. These changes were made to improve the targeting of benefits to those in the most need. As a result, Australians in the lowest 3 income deciles saw their net benefits increase between 1984 and 1989, while those in the 4th through 10th deciles saw their net benefits reduced.

In 1989, the Canadian government ended the universality of its old age pension by introducing a "claw-back" tax on benefits. Under this change, seniors were required to repay a portion of their old age pension for every dollar of net income above a certain threshold; for some, 100 percent of the benefits were repaid.

Through a series of steps, the Canadian government also ended the universality of its child benefit programs. The universal family allowance program in Canada was ultimately replaced in 1993 with a form of refundable child tax credit, which does not provide universal benefits.

Capital Investment Was Reduced

Officials in most countries told us that the central government reduced capital spending as part of their deficit reduction strategy in the 1980s. In Mexico, capital spending was cut in half as a percent of GDP between 1982 and 1991. The German government reduced capital spending at all levels of government between 1981 and 1984, even though investment spending is exempt from the constitutional requirement to balance the budget. The Australian government reduced its own capital outlays as well as capital

assistance to the states. Officials in several countries told us that reducing or slowing the growth in capital spending was an easy and quick way to cut overall spending. Also, part of the reduction in investment spending in some countries resulted from privatization and the reduced responsibility of government to provide capital investment for nationalized industries.

Japan represents the main exception to this trend; the ratio of public sector investment spending to GDP did not decline. Although the central government reduced capital outlays in Japan during the 1980s, local governments, interest-free loans from the proceeds of privatization, and a national investment program called the Fiscal Investment and Loan Program (FILP) have kept capital spending from falling from its long-term average.

Regardless of how investment cuts were implemented, reducing capital spending can be counterproductive to a nation if it continues for any significant length of time. Economists agree that public and private investment is critical to long-term economic growth. Moreover, cuts in capital investment only defer eventual costs that will have to be addressed in future budgets. In the late 1980s, the Mexican government tried to address some of the more pressing capital and social needs by implementing a development grant program for poorer communities.

Payments to Lower Levels of Government Were Reduced

The central governments in Australia and Canada sought to reduce their deficits in part by reducing payments to the lower levels of government—states and provinces. Officials at these lower levels and some budget experts portrayed reduced transfers as a way of shifting deficits from the federal to the state level. On the other side of the argument, federal officials in both countries said that cuts in transfers to the states and provinces were necessary to share the pain of deficit reduction, particularly when, at the time, some states were enjoying relative fiscal health.

Figure 3.4: Federal Cuts to States and Provinces

In Canada and Australia, the central governments reduced payments to lower levels of government as part of their deficit reduction efforts. Provincial deficits as a whole remained relatively small throughout the 1980s in Canada, but the provincial deficits quickly expanded at the beginning of the 1990s, partly due to cuts in federal aid. In Canada, transfers to other levels of government equaled 21 percent of total federal expenditures in 1980; by 1993, the transfers had been reduced to 18 percent. The federal government has limited the growth of health care related transfers to the provinces; however, since health care is primarily a provincial responsibility, these costs have continued to contribute to the deficits of provincial governments and have prompted corresponding cuts at that level. For example, the province of Ontario reduced health care spending from 10 percent growth a year in the 1980s to 1 percent in 1993. Canada ranks second highest among OECD countries, behind the United States, in health expenditures per capita.

In Australia, the government decided to reduce its deficit in part by reducing general purpose payments to the states. In 1983, Commonwealth payments to the states were 32 percent of total outlays. In 1993, they had been reduced to 29 percent. This lost revenue was masked for a time by a boom in the property market that kept state stamp and other transaction taxes high. When the real estate market subsequently plummeted, the states found themselves in trouble. All six Australian states saw revenues decline as a percent of gross state product between 1983 and 1990, due in part to reductions in payments from the Commonwealth.

In the other federal systems in our study, Germany and Mexico, this shifting was not as significant. The reluctance to make large reductions in transfers to the states in Germany was due in part to the fact that the

upper house of parliament (the Bundesrat) is made up of state representatives. The German constitution requires Bundesrat approval for all tax proposals and for spending that affects state responsibilities such as education, crime, housing, and family allowances. Since the Bundesrat is made up of representatives of state governments, the interests of the states are given much weight in budget deliberations. In Mexico, those we interviewed said federal payments to states were not greatly affected by the deficit reduction efforts of the 1980s.

Public Employment Reduced and Wage Increases Restricted

Streamlining government and making the public sector more efficient were consistent themes across all the case study countries. This was accomplished by a reduction in public sector employment and freezing or limiting the growth of public sector wages. In the United Kingdom, the number of public sector employees was reduced by 26 percent between 1980 and 1992, from around 6.6 million to 4.9 million, partly reflecting privatization efforts. In Germany, the government limited and delayed pay increases and hired larger numbers of part-time employees in order to realize savings. In Canada, the government reduced the number of public sector employees by roughly 4 percent and froze public sector wages.

Privatization Was Undertaken to Reduce Government's Role in the Economy

Privatization—shifting ownership from government to the private sector—of assets and agencies was undertaken by case study country governments primarily for policy, rather than for fiscal, reasons. Governments benefitted from one-time increases in revenues and permanently reduced liabilities as a result of selling enterprises to the private sector, but they undertook privatization primarily to reduce the role of the public sector in the economy and to make the remaining public sector more efficient.

While most governments in our study engaged in some kind of privatization program, the United Kingdom and Mexico were able to use this strategy to the greatest extent, principally because they had large nationalized industries at the beginning of the 1980s. Also, officials in Mexico described how the government had been involved in industries or businesses that it could not run effectively. In Mexico, the first stages of privatization were marked by the closing of these nonviable firms.

The government in the United Kingdom is a clear example of privatization as part of a political agenda. The Conservative government elected in 1979 stated its goal was to reduce the role of the public sector in the economy.

The fact that the government excluded privatization proceeds from its spending limit calculations suggests that the motivation for privatization was more political than it was fiscal. The government sold nationalized industries to the private sector, sold public housing to individual owners, and contracted out more government services. By 1992, two-thirds of nationalized industries and over 930,000 jobs had been transferred to the private sector.

The Mexican privatization effort was aimed at improving the efficiency of the economy and strengthening public finances. Industries and businesses were privatized slowly over the decade in a deliberate effort to learn from both direct experience and the experience of other nations. The number of public enterprises dropped from 1,155 in 1982 to 217 in 1992. Revenue from privatization equaling 6.3 percent of GDP has been realized since 1989.

Most Revenue Actions Were Not Linked to Deficit Reduction

Most revenue actions were not designed or initiated to reduce budget deficits but were undertaken for reasons such as tax efficiency and equity. Although tax changes were, on the whole, revenue-neutral, most governments in our study retained the real revenue increases resulting from inflation by not fully indexing income tax brackets for inflation every year. Moreover, several countries shifted more of the tax burden from direct taxes to indirect taxes—that is, by decreasing income taxes and increasing consumption taxes.

Figure 3.5 shows major tax policy actions taken by case study governments during the 1980s.

Figure 3.5: Major Tax Actions

	Cut income tax rates	Instituted new or higher consumption taxes	Increased other taxes	Reduced tax expenditures	Changed indexation	Improved enforce-ment
Australia	●	○[c]	●	●	○[a]	◒
Canada	◒	●	●	◒	●	○
Germany	●	●	●	●	○[a]	○
Japan	●	●	◒	○	○[a]	◒
Mexico	◒	◒[b]	○	●	◒	●
United Kingdom	○	●	◒	●	●	○

Legend
● Major action
◒ Action taken, but to lesser degree
○ No significant action taken

[a]Tax system not indexed.
[b]The Mexican government increased the value added tax in the early 1980s and reduced it again in the early 1990s.
[c]The Australian system does not have a value added tax, although it does have a wholesale sales tax.

Tax Reform Intended to Be Revenue Neutral

Most of the countries we studied enacted some form of tax reform during the 1980s, but these changes were largely revenue neutral, as governments sought to protect their revenue bases by combining tax cuts in one area with revenue increases in another. In general, tax reform included some combination of reducing top tax rates, reducing tax expenditures,[3] and increasing consumption taxes. Increased tax enforcement was also an important factor, most noticeably in Mexico.

Raising income tax rates did not seem to be a viable deficit reduction option. In some cases, such as in the United Kingdom and Germany, the government was publicly committed to lowering income tax rates. Analysts suggested that the tax reforms undertaken by the United States during the 1980s, particularly income tax rate cuts, influenced governments in other countries and made raising income taxes politically unattractive. In an increasingly integrated global economy, governments that raise tax rates above their international competitors may suffer

[3]Tax expenditures are revenues foregone, or revenue losses, due to preferential provisions of the federal tax laws, such as special exclusions, exemptions, deductions, credits, deferrals, or tax rates. See Tax Policy: Tax Expenditures Deserve More Scrutiny (GAO/GGD/AIMD-94-122, June 3, 1994).

capital flight as multinational businesses seek to locate operations and financial transactions in lower tax countries.

Although several governments reduced tax rates, they also sought offsetting revenue from broadening the tax base or increasing consumption taxes to avoid increasing the deficit in either the short or longer term. In some countries, consumption tax increases were directly linked to offsetting income tax reductions. For example, Japan reduced income tax rates in exchange for instituting a 3 percent value added tax (VAT) in 1989. Three years after reducing income tax rates, the Canadian government introduced a new value added tax to replace its old manufacturers' sales tax.

Although tax reform was characterized by governments as revenue neutral, some taxes were increased, and some tax expenditures were reduced for deficit reduction purposes. For example, the Australian government instituted taxes on fringe benefits and capital gains. In 1989, the Canadian government ended the universality of its old age security pension by introducing a "claw-back" tax on benefits. Canadian seniors were required to repay a portion of their old age security pension for every dollar of net income above a certain threshold up to 100 percent repayment of the benefit.

Tax expenditures were eliminated or modified in several of the case-study countries. The German government raised revenue by reducing tax allowances and loopholes between 1982 and 1990, eliminating 62 tax expenditures in 1990 alone. The Australian government eliminated the deduction for entertainment expenses and reduced tax concessions to the filmmaking and petroleum industries in its 1986-87 budget. Officials in Mexico said that tax reform in 1987 eliminated major tax expenditures benefiting the agriculture and transportation sectors of the economy.

Oil Revenue Was Important in Mexico and the United Kingdom

The governments of Mexico and the United Kingdom enjoyed significant revenue from the sale of oil during the 1980s. While oil revenue did not preclude other deficit reduction efforts, it did significantly affect the countries' progress, in both positive and negative ways.

On the positive side, both Mexico and the United Kingdom benefited from oil revenues throughout the 1980s. High oil prices allowed these countries to bring in additional revenue. At its peak in 1984, North Sea oil proceeds in the United Kingdom represented almost 8.5 percent of total tax

revenues. In Mexico, oil revenues were approximately one-third to one-half of total public sector revenues between 1980 and 1990.

On the negative side, the Mexican government's dependence on oil seemed to contribute to the country's deficit problems. Large oil reserves were confirmed in the mid-1970s, and analysts argue that the new-found wealth permitted the government to defer imposing fiscal austerity. Spending levels in the late 1970s and early 1980s were increased to take advantage of high projected oil revenues and were maintained, even when prices fell. However, once spending was reduced, oil revenues contributed to improving the deficit situation.

Tax Systems Yielded Increased Revenue

Although few governments used tax legislation directly to significantly reduce the deficit, revenues nonetheless contributed substantially to achieving this fiscal goal. Total public sector revenues as a percent of GDP increased during the 1980s in Canada, Australia, and Japan and remained relatively stable in the United Kingdom, Germany, and Mexico.

Strong economic growth in the mid-to-late 1980s increased tax revenues in several countries. Virtually all of the increased revenue was available to reduce the fiscal deficit because by this time expenditures were in most countries tightly controlled. Furthermore, unindexed tax systems, or tax systems periodically indexed at the discretion of the government, afforded governments the ability to retain revenue resulting from inflation, often referred to as "bracket creep." As a result, governments could reap large tax revenue gains automatically, which contributed substantially to the attainment of budget balance or surplus.

Without indexation, governments may choose not to adjust income tax brackets to reflect inflation, and "bracket creep" can occur. Individuals or businesses may move to higher income tax brackets even though their real (inflation-adjusted) incomes remain constant, thus raising real tax revenues without directly changing tax rates. Countries used this bracket creep to help bring in additional revenues. The Japanese government, which had previously returned bracket creep in the form of tax cuts, has not done so since 1974. The German government instituted tax rate cuts in the second half of the 1980s, only after several years of fiscal restraint. A government in Australia experimented with indexation of its tax system in the 1970s, but abandoned it because it was too restrictive and mechanistic, and political leaders were placed in the difficult position of having to take action to recoup lost tax revenue.

A similar effect was achieved by suspending or modifying the indexation of taxes. The government in the United Kingdom suspended indexation for one year, lowering the income base on which future tax bracket adjustments were made. The Canadian government modified the indexation formula so that tax bracket adjustments are now made only when inflation exceeds 3 percent.

Table 3.2 provides information on the indexation of taxes in the case study countries.

Table 3.2: Indexation of Taxes

	Is Tax System Indexed?
Australia	No. Government periodically returns bracket creep through tax rate cuts.
Canada	Partial
Germany	No. Government periodically returns bracket creep through tax rate cuts.
Japan	No. Japan used to return bracket creep in the form of tax rate cuts, but has not done so since 1974.
Mexico	Yes
United Kingdom	Yes. Officially, indexation is automatic unless government takes action to set indexation independently. In practice, government sets rate each year.

The Role of Budget Process Reform

The governments of two case study countries, Australia and the United Kingdom, instituted changes in budget processes to help implement or fortify their deficit reduction strategies. In contrast, the governments of Germany, Japan, and Mexico were able to accomplish deficit reduction with the aid of relatively little process change. Although the Canadian government instituted management and budget process reforms during the late 1970s and the 1980s, it was not successful in eliminating its budget deficits.

The Australian government used management and budget reforms to implement deficit reduction and to maintain budget discipline during the 1980s. Management reforms like the Financial Management Improvement Program were coupled with budgetary reforms that centralized and made budget decisions more transparent. Budgetary reforms included a top-down cost estimating process called the "forward estimates," which helped rationalize fiscal policymaking by defining a uniform baseline against which to assess agency proposals. A "running costs" system was also instituted that accounted and budgeted for administrative costs; in

exchange for greater flexibility in allocating resources within this category, agencies had to reduce administrative spending by a certain percentage each year. In addition to their stated objectives, these reforms also helped the government to promote deficit reduction as part of a larger strategy to make both the government more efficient and the economy more competitive.

A significant process change also occurred in the United Kingdom, where the base for budgeting changed from volume planning to cash planning. Prior to the change, program spending was estimated for a series of years based on the funds needed to provide a constant level of services taking inflation into account. When inflation or other demands caused department budgets to increase, additional funds would generally be provided. This system provided little control over total spending. Over the latter half of the 1970s and into the early 1980s, the government gradually replaced volume planning with overall spending totals and explicit cash limits for sectors of the budget. The Labor government of the mid-1970s began the process of changing over, but the Thatcher government fully implemented the system for the entire budget.

Although reforms played a part in the deficit reduction story of some of the case study countries, we found that reforms alone did not guarantee successful deficit reduction. The Canadian government sought to reduce public spending and improve quality of public services by launching reforms during the 1980s in a variety of program areas including social services. Although the central government had some success in reducing program spending as a percent of GDP between 1984 and 1990, it could not reduce its budget deficit below 3 percent of GDP. Although reforms in some countries unquestionably aided governments in controlling, implementing, and tracking their budget and policy decisions, most did not rely on automatic mechanisms to make the tough budget choices.

Deficits Have Recurred

As discussed in chapter 1, four of the five nations achieving balance or surplus are projected to have budget deficits in 1994—Japan, Germany, the United Kingdom, and Australia. According to OECD calculations, Japan's deficit is entirely cyclical and not due to structural imbalance in the budget.

While budgets in Germany, the United Kingdom, and Australia were affected by cyclical downturns in the early 1990s, the governments in these countries also made policy decisions that caused an underlying structural

deficit to reemerge. The German government's budget moved back into deficit in large part as the result of the unification of Germany in 1990. The Australian and United Kingdom governments began "giving back" some of the benefits taken away under the austerity programs of the 1980s.

This apparent retreat from fiscal discipline typically occurred during or after periods of strong economic growth which benefited the budget beyond the structural improvements already achieved. These cyclical dividends from economic growth made the fiscal position appear better than warranted by the fundamental structural balance. Political leaders, faced with apparent fiscal prosperity and the easing of previous economic concerns, made budgetary decisions that reduced the structural progress previously achieved. When recessions struck in the early 1990s, these governments' budgets returned again to large deficits.

This experience suggests it is difficult to sustain austerity over a prolonged period of time. Demands and needs delayed or deferred during periods of fiscal austerity reemerge on the public agenda, and leaders have a more difficult time legitimizing constraint once budgets and the economy appear to be healthy. Nevertheless, deficit reduction provided significant fiscal benefits by reducing public debt and government interest costs. The countries' total debt levels would be higher today if their current annual deficits were added to bases not reduced by several years of austerity. In addition, some economists believe that the countries, thanks to these earlier increases in savings and investment, should experience improvements in long-run living standards that would not occur otherwise.

Germany offers a particularly good example of the continuing benefits of even temporary fiscal balance. Although the German budget has fallen back to deficit, it has done so primarily as a result of the unification of the former East and West Germanies. Fiscal strength certainly aided the West German government's case for unification; although unification may have proceeded regardless of West Germany's fiscal health, the fiscal austerity of the mid-1980s not only facilitated union, it has also kept debt and deficit levels lower than they would have been otherwise.

Leadership Strategies Promoted Broad Support

Political and public support proved crucial to successful fiscal change. Government leaders fostered support for their policies by linking deficit reduction with an improved economy and by building consensus with key interest groups on how to approach deficit reduction. Additionally, deficit reduction strategies themselves were designed not only to achieve fiscal balance, but also to promote political support through trade-offs, shared sacrifice, and deferred pain. Over time, despite tough fiscal policies, these governments were returned to office, in some cases, several times.

Deficit Reduction Linked to Clearly Defined Economic Goals

Governments in most of the countries linked deficit reduction with perceived short- as well as expected long-term economic gains. Although improving international competitiveness and long-run fiscal health proved compelling goals in some countries, most also pointed to shorter run benefits such as reduced inflation, stabilized currency values, or reduced interest rates to make the benefits of austerity more concrete. Improvements in living standards that result from deficit reduction are normally realized only over the long term. However, deficit reduction in most case study countries was only one element of an overall economic strategy. In combination with the other elements of the governments' economic policies, deficit reduction contributed to reductions in inflation and interest rates, and increasing rates of economic growth in the 1980s.

Emphasizing Shorter Term Economic Benefits Helped Garner Support

Linking the effects of deficit reduction with an improved economy appeared to make fiscal sacrifice more palatable to the public. Several governments linked fiscal deficits to inflation and identified deficit reduction as a means to attack the problem. This occurred in the United Kingdom, where deficit reduction was seen as part of a larger strategy to reduce inflation. In Germany, too, deficit reduction was intended to address an unacceptable inflation rate as well as reduce rising interest rates. Mexico, in crisis, presented deficit reduction as the answer to triple-digit inflation. The public in these countries seemed to understand that inflation would erode the standard of living in the near term.

Other short- and medium-term economic concerns stimulating strong public interest included strengthening the currency in some nations and reducing interest rates in others. Governments took the position that reducing budget deficits, along with other policies such as deregulation and free trade policies designed to increase competitiveness, would be fundamental to achieving these goals. This approach seemed to strengthen

government arguments that the benefits of deficit reduction outweighed the costs.

Long-Range Benefits of Deficit Reduction Were Also Clearly Communicated in Some Countries

Some governments were able to convince the public that sacrifice in the form of deficit reduction, with other economic policy measures, would be rewarded with long-term economic gain manifested in sharpened competitiveness and improved growth in living standards. Although these arguments were buttressed by discussion of short-and medium-term benefits as well, the governments of Australia and Mexico successfully argued for deficit reduction in part as a way to modernize these economies and ensure continued competitiveness in world markets. In Australia in particular, concern that the fiscal deficit compromised future living standards proved instrumental in building public support.

Only the Japanese government focused primarily on the long run alone, emphasizing both the problem of increasing budgetary inflexibility due to rising interest commitments and the importance of building an operating surplus to finance the needs of future retirees. This approach successfully appealed to the public's high preference for savings.

Main Economic and Political Interests Involved

Leaders succeeded in using these various appeals to promote a new sense of urgency about the deficit. Opposition parties and interest groups then had little choice but to frame their policies in a fiscal austerity context. In Australia, for example, the opposition party at times engaged in something of a bidding war over whose policy alternatives promised the greatest amount of deficit reduction. Some interest groups also reported that they felt they could not credibly propose new initiatives without identifying a source of funding at the same time.

Having made a politically compelling case for deficit reduction, governments in many of the six countries then engaged in some form of consensus building to create support for their fiscal policies. In these countries, key labor and business interest groups affected by deficit reduction and instrumental to achieving economic reform were successfully brought into the decision-making process, although not without difficulty and cost. Interests representing social welfare concerns were also consulted in some countries, but to a lesser extent.

Labor and Business Groups Involved

As we observed in chapter 1, deficit reduction involves imposing losses that are directly and keenly felt to gain benefits that are widely dispersed.

The imposition of such loss constitutes, therefore, a potential political hazard for the leaders attempting it. It is therefore remarkable that governments we studied managed to bring the representatives of their countries' most important political and economic interests "to the table" to negotiate economic policy, including deficit reduction and, ultimately, the imposition of loss. Such negotiation often required the government to grant concessions to these groups, which sometimes increased spending in other areas.

In Australia, Mexico, and Germany, interest groups representing labor and business participated in government efforts to build consensus for its fiscal policies. The Mexican government formalized the consensus-building process by creating a multi-interest group that met initially to adopt an overall fiscal and economic strategy, and later to review agreements and priorities to ensure continued progress. In Australia, the government interacted primarily with the unions; business and social welfare interest groups were also consulted, but to a lesser degree. In Germany, labor representatives held seats in the legislature, so they were regularly consulted as part of intragovernmental consensus building. Although the degree to which these groups were involved varied, obtaining their support or at least preventing their active opposition was important to the success of deficit reduction efforts in these three countries.

The Japanese government worked closely with business interests through an administrative reform commission in imposing spending reductions. By linking austerity with the private sector's interest in efficiency and deregulation, the Japanese government garnered support for its fiscal austerity measures, which included tightly controlled spending levels.

Such alliances were limited in the United Kingdom and Canada. In the United Kingdom, the Conservative government's large parliamentary majorities enabled the government to undertake potentially controversial actions without the same level of formal consultation seen elsewhere. However, Canada's Progressive Conservative government, also elected on a platform that included reducing the deficit, was reluctant to take strong unilateral measures and was unable to produce consensus to pursue particular strategies. We were told that this was the result of, in part, a fragmented political structure. The two levels of government in Canada, the provincial and the federal, often have disparate or competing incentives. For example, concerns about the potential secession of Quebec

have made it difficult for the government to undertake deficit reduction measures that adversely affect the provinces.

Consensus Building Within Government Was Also Important

Although party loyalty is often considered the hallmark of parliamentary systems, such loyalty should not suggest imposing austerity is therefore easy in such systems. Intragovernmental consensus building proved an essential element in several countries' austerity plans. Such consensus building was deemed necessary either to submit an austerity plan to parliament or to ensure such a plan, once passed, would be implemented. Sometimes, government plans were defeated or modified due to internal pressures.

Several examples help demonstrate this point.

- Germany. Under the German system, state governments control the upper house of parliament (the Bundesrat) and as a consequence had to be part of any fiscal solution proposed by the governing party. The interests of the states are given much weight in budget deliberations and influenced the Chancellor's approach to deficit reduction.
- Australia. Prime Minister Hawke's cabinet represented a range of Labor Party ideology and interests; the strongest interests were represented in a small group of Cabinet members convened to control spending, apparently to ensure all were "on board" when politically difficult spending cuts were enacted.
- Japan. Despite the apparent strength of the Ministry of Finance (MOF), intragovernmental consensus building traditionally took place prior to final budget submission to the Diet and involved the legislature, MOF, and the spending ministries negotiating the details of final budget levels.
- United Kingdom. Although the large parliamentary majority and election mandate meant the Prime Minister could enact government proposals relatively easily, achieving consensus within the government on such proposals was more difficult. Members of the Cabinet opposed to strong fiscal measures—informally called "the wets"—caused "the drys" to proceed cautiously on some particularly contentious tax measures, forcing the drys to accept greater wet involvement in the usually secret budget preparations. For example, a proposal to increase the gasoline tax in the 1981 budget was met with considerable discontent by the wets. The drys agreed to confine the duty increase to one specific type of fuel indexed to the increase in inflation, and to increase the tobacco duty as an offset to this. As a result of the compromise, the budget passed without any overall change in the budget totals.

When governments were not able to negotiate a consensus within their own party, we found many examples where the deficit reduction measures were not adopted. For example, in Australia, the Labor government proposed in its August 1993 budget to eliminate optometry benefits from the health program and thus save an estimated 345 million Australian dollars over 4 years. A group within the Labor Party did not agree with the decision and forced the government to reinstate the benefits before it would support the budget. In Japan, the Liberal Democratic Party (LDP) government attempted to introduce a value added tax in 1979, but the tax was highly unpopular, both with the public and with various factions within the Diet. The lower house of the Diet was forced to dissolve in 1980, largely due to the inability of its members to reach consensus on the VAT issue. The government ultimately succeeded in passing the VAT in 1989, but had to offer an income tax reduction and simplification in exchange for the new tax.

One nation we visited—Canada—did not reach fiscal balance. Despite earlier progress, the federal deficit in Canada grew to 4.6 percent of GDP in 1993. While the central government in Canada has implemented a variety of deficit reduction measures, there has been a lack of unanimity among government leaders regarding deficit reduction, and the government has allowed other priorities to inhibit its deficit reduction efforts. One reason for this may be the fragmented political structure of the country, as epitomized by the threat of Quebec secession, which has made it difficult for the government to build consensus and carry out strong unilateral measures. The mixture of the provinces' heavy fiscal dependence with their political independence has made any fiscally meaningful deficit reduction measures appear politically hazardous for central government leaders.

Austerity Strategies' Design Helped Defuse Opposition

The specific strategies used to reduce the deficit also helped promote support and defuse or mollify potential opposition. Such approaches as trading off program reductions for benefits (but retaining a net spending reduction); pursuing "shared sacrifice" strategies; and deferring, shifting, or obscuring painful adjustments all helped maintain support for governments' spending reductions.

Moreover, success in maintaining support can also be explained by what was not done—with the exception of privatization in the United Kingdom and Mexico, significant changes in government roles and responsibilities

did not occur. Significant deficit reduction did not require elimination of major programs or termination of significant benefits. Rather, reductions were largely achieved through decremental actions reforming, targeting, or streamlining government programs and operations.

Trade-offs Gained Support

In some countries, the government made the pain of expenditure reduction palatable to the affected groups through policy trade-offs. From the beginning of its tenure in the 1980s, the Labor government in Australia seemed to understand that its ability to marshall support for fiscal restraint in certain program areas would be facilitated by making trade-offs in the form of expanded or new benefits in other areas. For example, universal health coverage was introduced in 1983 as part of the trade-off for wage moderation, even though economywide wage restraint was not so much a budgetary savings as it was part of the government's effort to improve Australia's competitiveness. By gaining union support for its broader economic and fiscal reforms, the government paved the way for substantive spending reductions in other social spending areas such as pensions, family allowances, and unemployment benefits. The Australian government used smaller-scale trade-offs to gain support for specific programmatic changes; leaders added resources to some programs while cutting larger amounts from others, "sweetening" the cuts and thereby gaining crucial political support for net spending reduction.

The Mexican government also engaged in an economywide trade-off; workers accepted lower real wages to avoid layoffs. Additionally, the government introduced a program of grants to poor areas. In both Australia and Mexico, the willingness of involved parties to make trade-offs seemed to stem from the conviction that doing nothing to reduce the deficit would be the worst possible policy choice.

The government in the United Kingdom engaged in trade-offs as the strength of its political mandate waned. Subsidies to local authorities were increased to deflect opposition to the proposed poll tax.[1] Also, offsetting compensation was offered to pensioners and families on public assistance to reduce the outcry against the extension of the VAT to domestic fuel.

"Shared Sacrifice" Was Important

In several of these countries the idea of "shared sacrifice" was instrumental in forging the necessary consensus to reduce expenditures. Some of the reductions described in chapter 3 called for "equal sacrifice"

[1]The poll tax was a highly unpopular local residence tax levied on all adults.

from interest groups, programs, and/or government departments and fostered the appearance of "horizontal equity." Groups or agencies were thought to be more likely to acquiesce to deficit reduction if they did not feel unfairly disadvantaged in relation to their competitors. For example, in Japan, we were told that MOF embraced an across-the-board approach because it minimized political debate over resource allocation.

Government operations generally absorbed their "share" of cuts, and in some countries more than their share. As discussed in chapter 3, countries engaged to varying degrees in efficiency improvements, which took the approach of privatization, streamlining, consolidating, and reorganizing. Some of these changes, as in the United Kingdom, resulted in large reductions in the number of public employees. However, some governments, most notably Mexico, simply reduced real public sector wages to reduce spending. Budget process and management reforms also provided a way for governments to share in the sacrifice of fiscal restraint.

Cuts that were targeted to upper income groups provided a type of "vertical equity" or progressivity. Canada "clawed back" the old-age pension benefits paid to the wealthy, while Australia means tested pensions and child allowances, and, in addition, used some of the budgetary savings to increase benefits to the poor.

Some Strategies Deferred or Deflected Costs of Deficit Reduction

Some countries adopted longer term strategies that delayed the real pain associated with deficit reduction. In these cases, policies were adopted that did not significantly cut current benefits or beneficiaries but rather phased in reductions affecting future beneficiaries. This kind of strategy was thought to give future beneficiaries time to adjust their plans without unduly disrupting the lives of current program recipients.

Such strategies were particularly important when cutting benefits that have been, in effect, capitalized in the value of property or in expectations of future retirement support. For example, the government in the United Kingdom established a ceiling on home mortgage interest deductions at a time when most taxpayers' deductions were far below the ceiling. However, because the ceiling was not indexed, inflation has now made the ceiling an effective cap on the deduction, without any subsequent action on the part of policymakers.

Countries used other strategies to defer or shift the pain associated with deficit reduction. Officials told us that cuts in capital spending were easier

to make than cuts in government operations. Reductions in assistance to state and local governments enabled national governments to, in effect, pass down the burden of deciding how to allocate cuts. The devolution of responsibilities to the private sector through privatization or to employers and employees through private pension mandates also reduced present and future fiscal burdens on national governments.

Policies regarding the indexation of taxes and benefits also served to lower the visibility of fiscal sacrifice. On the revenue side, the absence of tax indexation in many of these nations enabled governments either to reap the fiscal dividends from inflation without overt tax increases or to give periodic tax "cuts." Modifying the indexation of pensions and other entitlements also proved to be a productive source of fiscal savings; the annual adjustments from such changes can be quite small but the cumulative impact over time can be substantial. For example, the shift in the basis of pension indexation in the United Kingdom from wages to prices had a small initial impact, but by 1988 the annual savings had grown to $4 billion as the differences between the two indicators widened.

Governments Returned to Office Despite Deficit Reduction Measures

During the period when these countries undertook fiscal austerity measures, governments in the five countries that balanced their budgets were re-elected, some several times. In Germany, the coalition government under Chancellor Kohl took over after a vote of "no confidence" in 1982; it immediately instituted its program of fiscal restraint and won general elections in 1983, 1986, 1990, and 1994. The Australian Labor government took over in 1983 and was returned to office four times in the next decade, once only 2 months after announcing a budget with large expenditure cuts. The Conservative party retained power in the United Kingdom throughout its deficit reduction efforts. Although the relationship between these fiscal policies and re-election is unclear, successful deficit reduction did not represent the electoral threat that some might expect.

Fiscal and Economic Benefits of Austerity

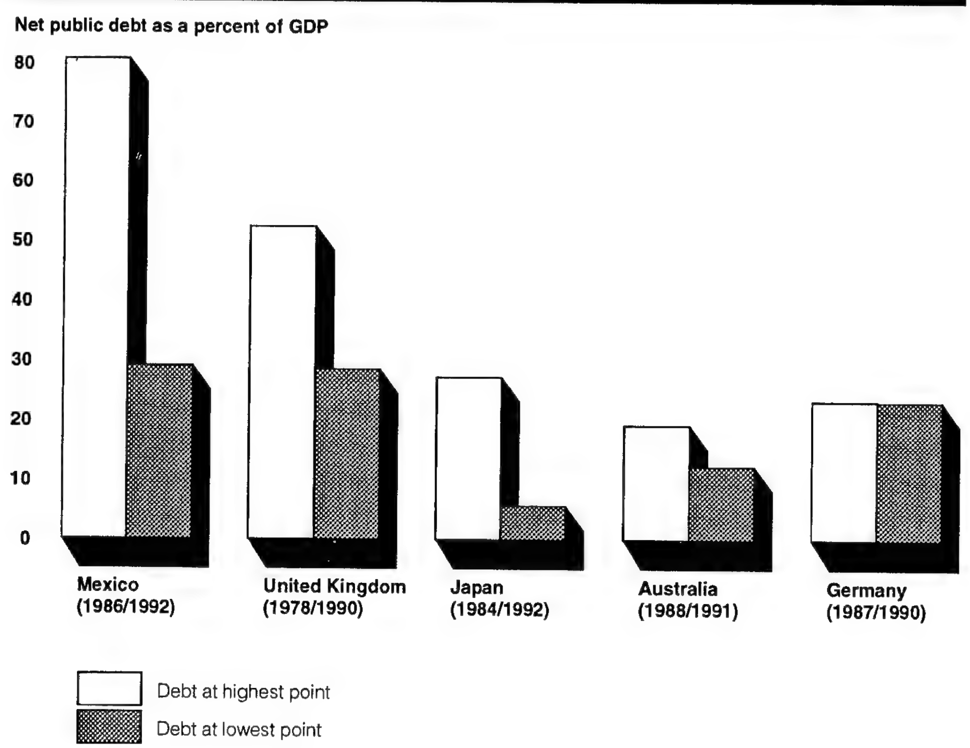
Deficit reduction provided significant fiscal benefits to which leaders could point in justifying painful measures. These benefits were realized by slowing or reversing the growth of public debt, thereby slowing or reversing the growth of interest costs. Moving from large deficits to surplus could turn what was previously a "vicious circle" of deficits, debt, and rising interest costs into a "virtuous circle" of surplus, debt reduction, and falling interest costs. Once the virtuous circle is set into motion, the

government regains the flexibility, previously restricted under budget deficits, to address new or emerging needs.

Figures 4.1 and 4.2 show the changes in debt and interest in the five countries that reached balance. Figure 4.1 shows the improvement in net debt balances in the five case study countries after deficit reduction. Figure 4.2 illustrates the improvement in the interest "bite"—interest payments as a percent of total expenditure—after deficit reduction.

Mexico offers the best example of the fiscal benefits. Where in 1986 debt was 81 percent of GDP, by 1992 it was 29 percent; interest costs, 50 percent of total current spending in 1987, dropped to 19 percent in 1992. By 1992, Mexico's debt levels were among the lowest of all the OECD countries.

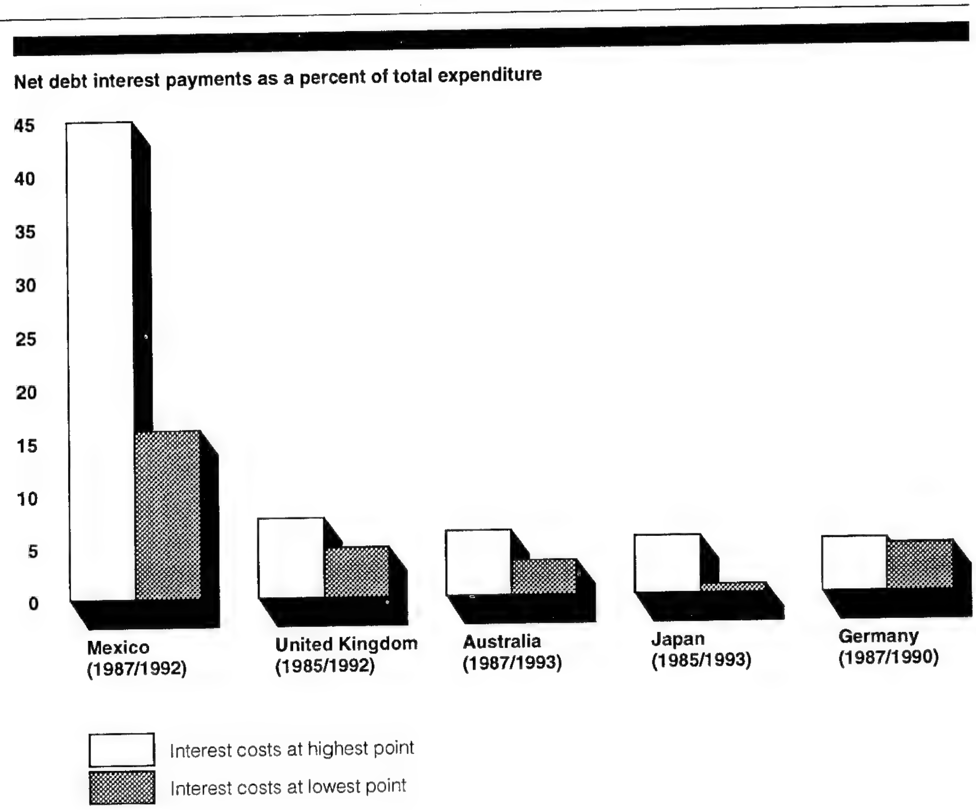
Figure 4.1: The Benefits of Deficit Reduction: Lowering Net Debt



Note: Mexico's 1992 data are preliminary.

Sources: OECD Economic Outlook, #55, and the Banco de Mexico.

Figure 4.2: The Benefits of Deficit Reduction: Lowering the "Interest Bite"



Sources: OECD Economic Outlook, #55, and the International Monetary Fund.

Reduction of public debt, in addition to the short-term effect of reducing interest costs, can improve economic growth in the long run. When deficits and debt fall, capital is freed for investment by the private sector, assuming no change in the rate of private saving. Economists point to increased investment as a key element of long-term economic growth and rising living standards. Although not enough time has elapsed to observe such changes resulting from the case study governments' deficit reduction, these benefits can be expected in the long run.

Deficit reduction's shorter run effects can be contractionary for the economy. However, many of the case study governments reported economic improvements shortly after embarking on austerity policies. Fiscal restraint generally has contractionary effects on demand in the short run, which can dampen economic growth unless offset by other

policies or events. Deficit reduction was, in most instances, one of several changes in the economic policies of the case study countries, and none of these governments reported such interim downward effects. Other economic policies and events may have acted to offset the dampening effects of deficit reduction. Government leaders were, however, able to point to positive changes that were a result of this mix of economic policies, such as reductions in inflation and interest rates and increasing rates of economic growth. For example, inflation in Germany dropped from 6.3 percent to –0.1 percent from 1981 to 1986, and long-term interest rates in the United Kingdom declined from 14.9 percent to 9.6 percent from 1981 to 1987.

Implications

The experiences of the case study countries show that significant structural improvement in fiscal policy is possible in modern democracies, although such progress is difficult to sustain. Each country's story demonstrates a different approach to deficit reduction, formed in part by the nation's political structure, economy, history, and culture. Similarly, fiscal policy in the United States also reflects unique cultural, political, and economic factors. However, particular elements of other nations' experiences may help the United States continue to address this common challenge.

Transferability of Other Nations' Experiences

Some might express skepticism about the transferability of deficit reduction experiences between different systems of government. Parliamentary systems are thought to facilitate controversial political action by consolidating power in the hands of the governing party. In contrast, the U.S. system's separation of powers is thought by some to present leaders with greater obstacles to political agreement.

Yet imposing fiscal sacrifice is a difficult task for any democratically elected government, irrespective of obvious differences between political systems. Prime Ministers, no less than Presidents, depend for their effectiveness on support both from the general public and interest groups.

Political leaders in our case study countries had to assemble coalitions to support deficit reduction just as Presidents and congressional leaders do in the United States for their own fiscal plans, and they had to retreat from proposals in several notable cases when the political opposition grew too heated. However, the form of consensus-building differs. Political bargaining in parliamentary systems generally occurs within the government, out of the public limelight and prior to the presentation of the budget, whereas bargaining in the U.S. system often occurs in public forums following the submission of Presidential or congressional proposals.

It may also be argued that economic differences affect transferability of fiscal experiences. The United States economy has no peer. As the world's largest and most diverse economy, it remains less vulnerable than others to the pressure of international financial markets. The large stock of accumulated wealth in the United States permits more borrowing than in smaller countries; similarly, a deficit of a given percentage of GDP may affect the United States less than much smaller economies. Thus, despite the chronic and large fiscal deficits of the 1980s, the United States had to

worry less about sudden and sharp reductions in the availability of capital than did some of the other economies we studied.

Despite these differences, deficits do matter to the U.S. economy as they do elsewhere. High real interest rates, expectations of rising inflation, declining value of the currency, decreased fiscal flexibility, and inadequate investment to support long-term economic growth can and have been linked to fiscal deficits, whether in smaller economies we studied, or the United States. Although leaders governing smaller economies such as Australia may feel external pressure to take action against deficits, leaders in larger economies such as Japan and Germany took decisive fiscal action partly in response to the kinds of concerns about the domestic economy expressed in the United States. Thus, many of the same pressures prompting action by other nations also concern U.S. policymakers—the differences appear largely in timing and magnitude.

Reaching and Sustaining Long-Term Fiscal Progress

In the United States, progress has been made in recent years to lower the deficit path, but projections suggest that the deficit problem worsens dramatically over the long run, particularly as the baby boom generation retires. Addressing this long-term problem thus presents the challenge of further reducing the structural deficit as well as sustaining such fiscal progress.

The experiences of five of the six nations suggest that resolving deficits is possible in modern democracies. Leaders succeeded in mounting the case for prompt action before crisis ensued, but they found sustaining the sense of urgency and the fiscal balance over extended periods problematic, in part because pent-up demands became more compelling once fiscal goals were achieved.

This suggests that policymakers can strive for fiscal progress and even fiscal balance when presented with windows of opportunity, as defined by cultural and economic factors that are unique to each nation. Although such fiscal goals will be difficult to sustain, deficit reduction strategies can be designed in a way to enhance the budget's long-term capacity to sustain fiscal progress.

The experience of the other nations and recent U.S. fiscal history suggest that prospects for reaching and sustaining balance can be affected by strategic fiscal decisions, including the following.

- Addressing the large and growing areas of the budget. As we have observed previously, meaningful long-term deficit reduction will be difficult to achieve if any of the significant deficit "drivers" or other major areas of the budget are not considered. Most case study countries kept both discretionary and mandatory spending programs available for reduction, even though health and pension programs did not always "drive" expected deficit growth as they do in the United States. Spending on entitlements by the United States has proven to be one of the most important deficit drivers, constituting almost half of non-defense federal spending in 1993.[1] Governments in several case-study countries nevertheless reduced major benefit programs by deploying three principal strategies: (1) involving affected groups in the decision-making process, (2) targeting benefit reductions to higher income groups, and (3) phasing in program changes to defer pain but ensure long-term fiscal improvement.
- Maintaining focus on the structural deficit. Cyclical economic growth provides fiscal dividends that can mask continued structural fiscal imbalances, fostering pressure to weaken austerity measures. Governments in other nations slackened their grip on structural deficits during periods of strong economic growth—the very times austerity policies are easiest for the economy to absorb and are often appropriate to contain the threat of rising inflation. This weakening of austerity in turn created structural deficits that became visible once again when cyclical growth receded. While not a panacea, a greater focus on structural deficit estimates could help policymakers better gauge the nature of the deficit problem by separating out the influences of short-term cyclical trends from the underlying policies driving longer term fiscal outcomes.
- Choosing strategies with positive long-term fiscal impact. Program changes that maintain or expand their positive fiscal effects over the long term are critical to sustaining fiscal progress. Some governments we studied employed strategies that expanded in impact over time. These "wedge-shaped" savings often had little effect at the time they were approved, but became fiscally more important as beneficiaries aged, inflation altered the impact of nominal floors or ceilings, or economies changed. Phasing in cuts affecting future beneficiaries also helped these governments ease the transition for affected groups, thereby promoting greater public support. Choosing such strategies calls for a fiscal planning horizon extending into the longer term future.

Generating public support for these strategies is also critical to long-term progress. Leaders in other nations were able to find the formula that

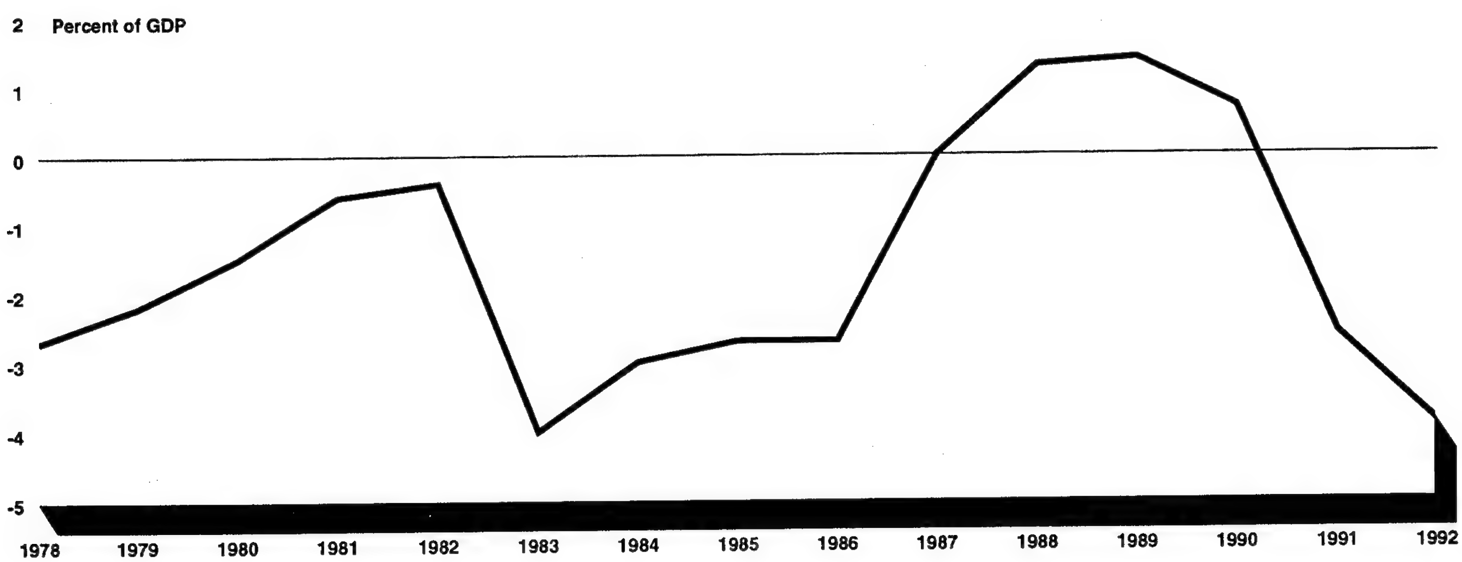
[1]Entitlement spending in the United States includes many programs, the largest of which are Social Security, Medicare, Medicaid, federal retirement, and unemployment compensation.

succeeded in mobilizing support for deficit reduction while minimizing the opposition of those bearing fiscal sacrifice. Making compelling arguments for austerity, employing effective fiscal strategies, and persevering on a fiscal path that successfully reached balance formed a basis for this achievement. Although it is never easy for leaders to ask their electorate to sacrifice benefits or income in the interests of broader goals, demonstrable and convincing progress on fiscal and economic goals ultimately helped leaders in other countries justify these fiscal sacrifices.

Commonwealth of Australia

The government of the Commonwealth of Australia made budget deficit reduction one of its highest priorities in the latter half of the 1980s in response to a widely perceived economic crisis caused by collapsing commodity prices, an overall deterioration in the terms of trade, and a fall in the value of the Australian dollar. Deficit reduction measures coupled with strong economic growth resulted in 4 consecutive years in which the budgets of the central government and the entire public sector were balanced or in surplus. (See figure I.1.)

Figure I.1: General Government Financial Balance in Australia, 1978-1992



Source: OECD Economic Outlook, #55.

By stressing the fall in the value of the currency, the government made Australians focus on how the government's fiscal imbalance could reduce their purchasing power and long-term standard of living. The sense of crisis and urgency was combined with a "bargained consensus" approach to decision-making to achieve a central government budget surplus in 1987 for the first time in over 35 years.

The Labor Party took control of the government in 1983 with an agenda focused on controlling inflation, reducing unemployment, restraining wages on an economywide basis, and establishing universal health care. Before the end of the decade, however, the Labor government had also allowed the value of the currency to float, deregulated financial markets, targeted pension and unemployment benefits towards the poor, restrained other government expenditures, increased some taxes and reduced others, and improved government's efficiency and effectiveness through management and budgetary reforms.

Background

The Commonwealth of Australia is a federation with three tiers of government: the national Parliament and government; 6 state governments; and about 900 local government bodies at the city, town, municipal, and shire level. The Commonwealth Parliament was established by the Constitution, which took effect on January 1, 1901, and is made up of the House of Representatives (148 members) and the Senate (76 members—12 from each state and 2 from each of the two most populous territories). The party or coalition of parties with a majority in the House of Representatives becomes the government and provides the Prime Minister. Cabinet Ministers can be selected from either the House or the Senate.

The two largest political parties in the Commonwealth Parliament are the Australian Labor Party and the Liberal Party of Australia. The Labor Party generally represents union interests while the Liberal Party represents more conservative constituencies. The other parties are the Australian Democrats, the National Party of Australia, and independents.

The Australian Council of Trade Unions (ACTU) enjoyed a close relationship with the Labor government during the 1980s. ACTU is an umbrella organization representing Australian unions, making it a large, centralized, and important interest group. Throughout its tenure in the 1980s, the Labor government negotiated formal wage and price agreements with ACTU and consulted with ACTU leadership on many issues. ACTU, in turn, supported many of the fiscal policy decisions made by the Labor government. The cooperation between the Labor government and ACTU during the 1980s is attributed in part to (1) the desire to overcome the popular perception that the previous Labor government (1972-1975) had been weak in matters of fiscal policy and (2) the general recognition that Australia needed to become more competitive internationally.

Responsibilities of Different Levels of Government

Commonwealth budget responsibilities include national defense, immigration, postal and telecommunications services, social security,[1] and welfare. State responsibilities include most public sector spending on education, health, public safety, and infrastructure. Local responsibilities include local roads and parks, libraries, and land use planning.

In Australia, the Commonwealth government collects more than three-quarters of the public sector revenue but is responsible for only about half of public sector expenditures. Commonwealth revenues come primarily from income taxes, sales taxes, and custom and excise duties. State revenue comes mainly from payroll taxes, business franchise taxes, and stamp duties. The Commonwealth government also transfers revenue to the states in the form of general and specific purpose grants. Local government revenue comes from property taxes, charges, and fines and a portion of the Commonwealth grants to the states.

Budget Process

The budget is put together by the ruling party government. While Cabinet Ministers and their departments are involved in submitting "bids" for funding, the Treasurer and the Minister for Finance are responsible for the budget. Because tough budget decisions need the eventual support of the entire Cabinet and the Parliament, the Labor government often used a subgroup of the Cabinet called the Expenditure Review Committee to make decisions on where to make budget cuts during the second half of the 1980s.

Generally, government budgets are passed largely intact by the Parliament. If the Parliament cannot pass the government's budget, it is viewed as a vote of no confidence and a new government must be formed. In 1975, a "double dissolution" of the Labor government under Prime Minister Whitlam and the sitting Parliament occurred when the Senate refused to pass the funding bills for government operations.

Impetus for Reducing the Deficit

After coming to power in 1983, the Labor government's goals were to reduce unemployment, control inflation, and stimulate the economy. The government entered into an agreement with ACTU to restrain wage growth in exchange for the "social wage" of increased social benefits. The government's economic reforms included allowing the value of the Australian dollar to float on world currency markets and deregulating the

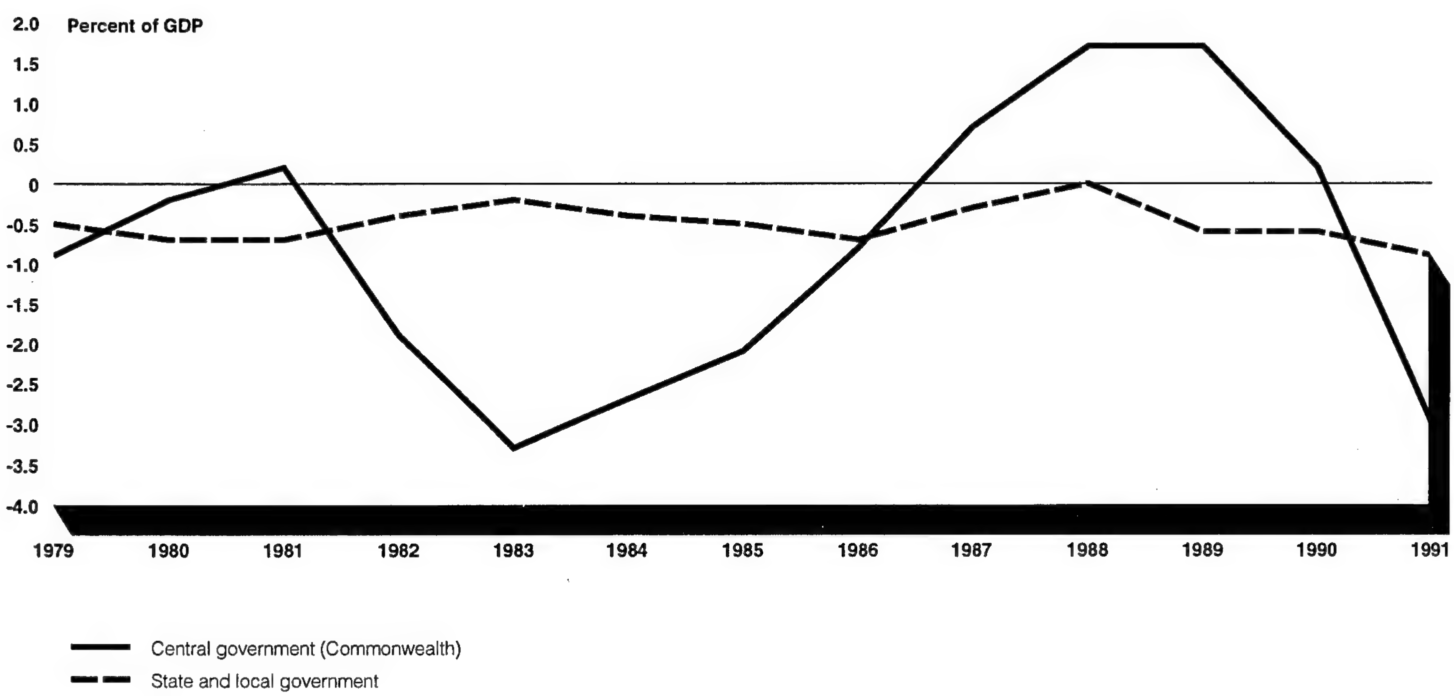
[1]The term "social security" refers to old-age pensions. Old-age pension payments are funded out of the general fund, and neither employers nor employees make contributory payments.

financial markets. By late 1984, however, the Labor government turned its attention to the budget deficits and was promising to reduce both the deficit and overall spending as a percentage of GDP.

Interviewees cited several factors that prompted the Labor government to take action to reduce budget deficits during the 1980s. Trade-related factors included large trade deficits and falling currency values. Other factors included the need to maintain international confidence and the decision to use primarily fiscal, rather than monetary, policy to address economic problems.

During the 1980s, deficit reduction efforts of the Commonwealth focused on both the deficit of the central government and on the total public sector borrowing requirement. Figure I.2 shows how OECD's deficit measure referred to as "net lending" compares for the central government and for state and local governments during the 1980s.

Figure I.2: Net Lending in Australia, 1979-1991



Source: OECD National Accounts, Volume II.

Deficits Were Entrenched

Before achieving a budget surplus in its 1987-88 budget year, the Commonwealth of Australia ran deficits almost every year since the 1953-54 budget. Although Commonwealth deficits were entrenched, they were relatively small—in the range of 0.5 to 2.5 percent of GDP—between 1953-54 and 1973-74. Fiscal restraint and deficit reduction had been discussed by the Labor government under Gough Whitlam (1972-1975) and some spending restraint undertaken by the Liberal government under Malcolm Fraser (1975-1983), but Commonwealth deficits were between 3 and 5 percent of GDP in the middle and late 1970s.

The oil shock in 1979 and the subsequent world recession, high wage-driven inflation, and a severe drought slowed progress on bringing down the deficit in the late 1970s and early 1980s. Experts we interviewed attributed high inflation of the early 1980s to a "wage blowout" of the late 1970s and early 1980s in which wages increased by as much as 20 percent in a single year. While wage increases were large, unemployment was also high, reaching almost 10 percent of the workforce by 1983. An ACTU official told us that during this time, the Australian worker saw that large wage increases did not translate into a higher standard of living, but rather simply fueled inflation.

1983 Through 1985: Increased Spending and Economic Growth

When the Labor government came to power in 1983, it had no formal plans to balance the budget nor to make deficit reduction a major priority. The 1984-85 Commonwealth budget reflected a real increase of 6.1 percent in outlays over the previous year due to the first full year of health care funding and election-year spending. In the 1983-1984 time frame, the Labor Government was trying to make room for new programs to which it was committed. Between 1983 and 1985 inflation decreased from 10.1 percent to 6.7 percent, unemployment fell from 9.9 to 8.2 percent of the labor force, and GDP growth was strong as the economy bounced back from a recession in 1982.

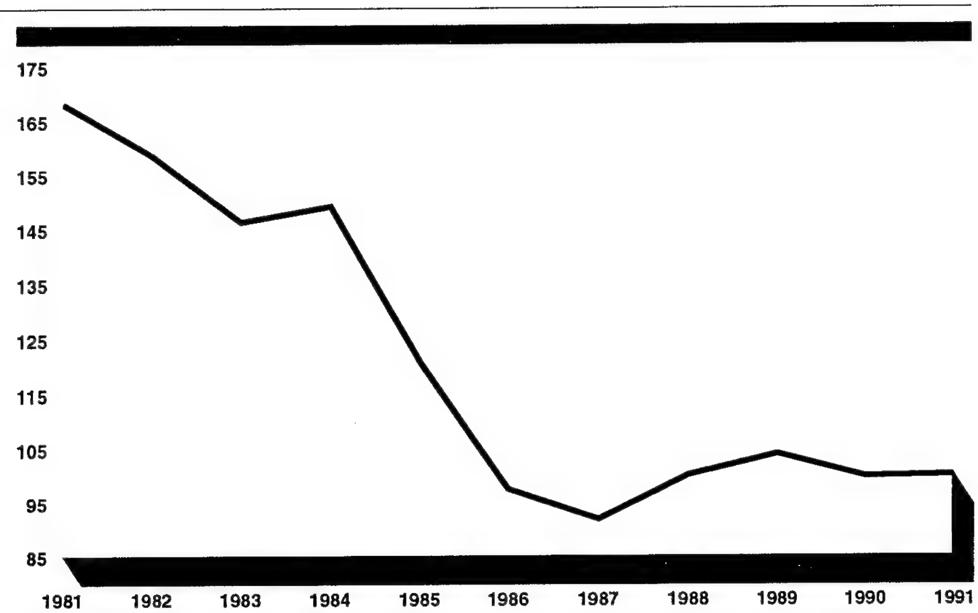
1985 and 1986: Economic Concerns and Perceived Crisis

Although the economy continued to grow, by 1985 there was widespread recognition that Australia's debt and trade positions were worsening. Government debt held by foreigners was increasing rapidly. In addition to mounting external debt, Australia's trade balance was in large deficit, and commodity export prices were falling. These factors caused concern over Australia's international competitiveness and future standard of living levels.

To combat these problems, Prime Minister Bob Hawke had put forth a set of fiscal goals referred to as the "trilogy" during the 1984 election campaign. The trilogy was a promise by the government that over the life of the next Parliament (1) there would be no increase in tax revenue as a percent of GDP, (2) government expenditure would not increase as a percent of GDP, and (3) the budget deficit would be reduced. The Commonwealth government set forth these goals officially in the 1985-86 budget in order to "cut back on public sector activity to provide scope for, and to encourage expansion in the private sector."

Deficit reduction became paramount in 1986 as a sense of economic crisis grew. As shown in figure I.3, the value of the Australian dollar declined by more than 30 percent against an OECD index of member-country currencies between 1984 and 1986. Australia's terms of trade—the ratio of export to import prices—fell by about 10 percent between mid-1985 and the end of 1986. The current account deficit—the value of exported goods and services less the value of imported goods and services—increased from 3.7 percent in 1983 to 5.5 percent in 1986. In May 1986, the Treasurer, Paul Keating, said publicly that Australia risked becoming a "banana republic" if it did not address its trade and budget imbalances.

Figure I.3: Effective Australian Exchange Rates, 1981-1991



Note: Index is average of daily rates with 1991 = 100.

Source: OECD Economic Outlook, #55.

At the end of July 1986, the Australian dollar dropped from 63 U.S. cents through the "psychological floor" of 60 U.S. cents to a low of 57 U.S. cents. Australian officials we interviewed, including the Minister of Finance during this period, said that the Labor government believed it was imperative to reassure foreign capital markets that something would be done to correct the problems. The world financial community did not see this situation as one that Australia could simply borrow or grow out of.

According to a senior official, in the midst of the crisis, Australian policymakers decided to reduce the federal budget deficit rather than raise interest rates. He said this was perceived by the international finance community as being a novel approach. The traditional response to this problem by other nations seemed to be to raise interest rates, prop up the currency, and cut demand. The Australian government decided to focus on the budget deficit because its leaders felt the economic problem was structural and long term and its resolution would only be postponed by raising interest rates.

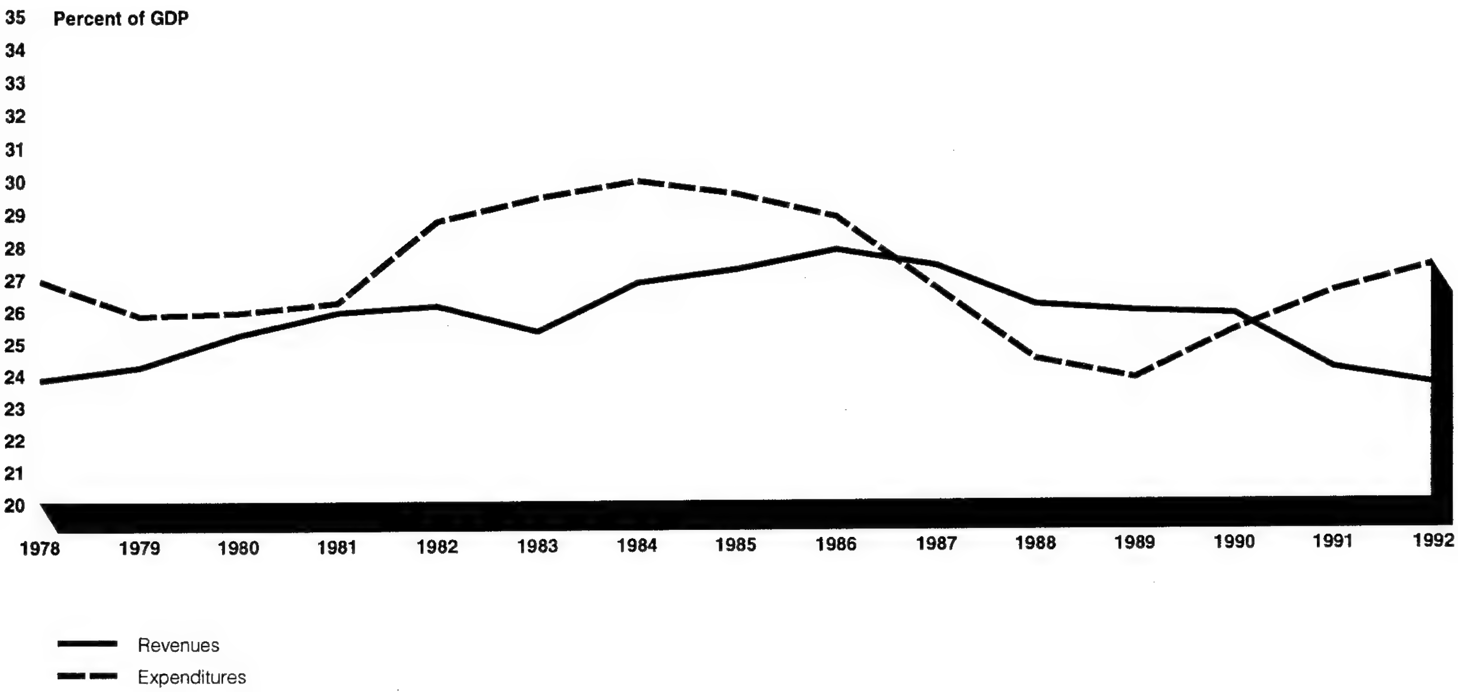
1986 to 1989: Sustained Expenditure Restraint and Economic Growth

As shown in figure I.4, outlays for the entire public sector decreased from 37.3 percent of GDP in 1986 to 32.8 percent in 1989. As shown in figure I.5, outlays for the Commonwealth government dropped from 28.8 percent of GDP to 23.8 percent over the same period. This was accomplished by keeping growth in Commonwealth budget outlays below the level of inflation (negative real growth), reducing investment spending and transfers to the states, and reaping the revenue benefits of a period of economic growth.

Figure I.4: General Government Revenues and Expenditures in Australia, 1978-1992

Source: OECD Economic Outlook, #55.

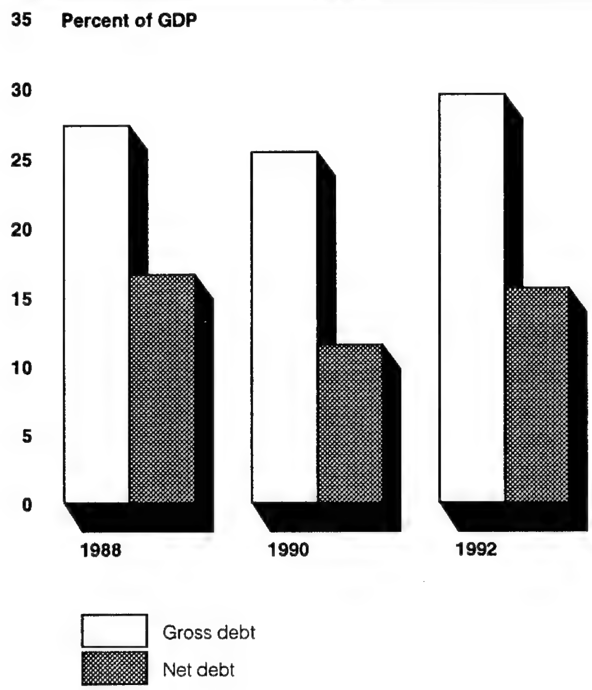
Figure I.5: Central Government (Commonwealth) **Revenues and Expenditures in Australia, 1978-1992**



Source: Australian Budget Paper No. 1, 1993-94.

Figure I.6 and I.7 show that overall public sector debt was reduced as a percentage of GDP and that net interest payments were reduced as a percentage of total public sector expenditures during the late 1980s.

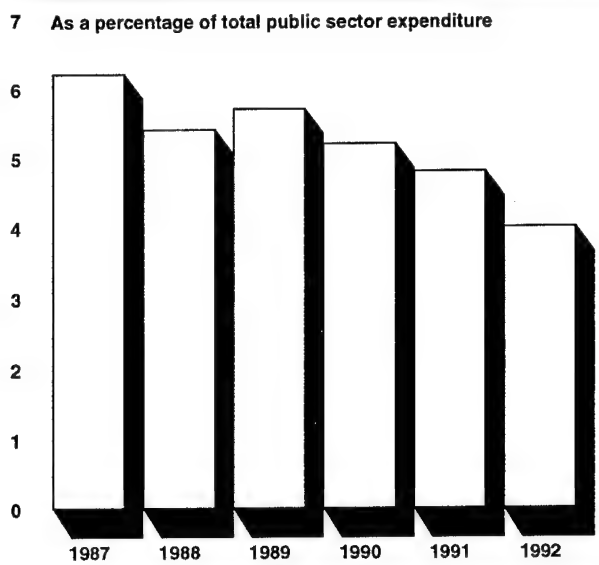
Figure I.6: General Government Gross and Net Debt in Australia, 1988-1992



Note: Data not available prior to 1987. Data for 1992 are estimates.

Source: OECD Economic Outlook, #55.

Figure I.7: General Government Net Debt Interest Payments in Australia, 1987-1992



Source: OECD Economic Outlook, #55.

Although ACTU endorsed deficit spending as a fiscal stimulus to combat recession in the first half of the 1980s, it also endorsed reducing government expenditure once recovery was under way. An ACTU official stated that one of the Whitlam Labor government's biggest mistakes was to not significantly cut back spending during economic recovery. These officials emphasized that this was a mistake that the Labor government did not want to repeat in the 1980s.

Deficit Reduction Actions

When the Labor government came into power in 1983, it persuaded ACTU to agree to real wage cuts in exchange for a "social wage" which included universal medical coverage, some increased social spending, and stimulation of the economy. When the Labor government moved its policies towards deficit reduction in the years 1985-1988, it generally maintained benefit levels but improved the targeting of those benefits through asset and income testing. In several social programs, targeting of recipients was tightened, including the family allowance, unemployment benefits, tuition assistance, and pharmaceutical benefits. Other important elements of the government's deficit reduction strategy were cutting

grants to the states, reducing investment spending, and selling assets. As figure I.4 shows, most deficit reduction came on the spending side after 1986. However, revenues had been allowed to increase as a percentage of GDP between 1983 and 1987 as a result of economic growth and an unindexed tax system.

Spending Actions

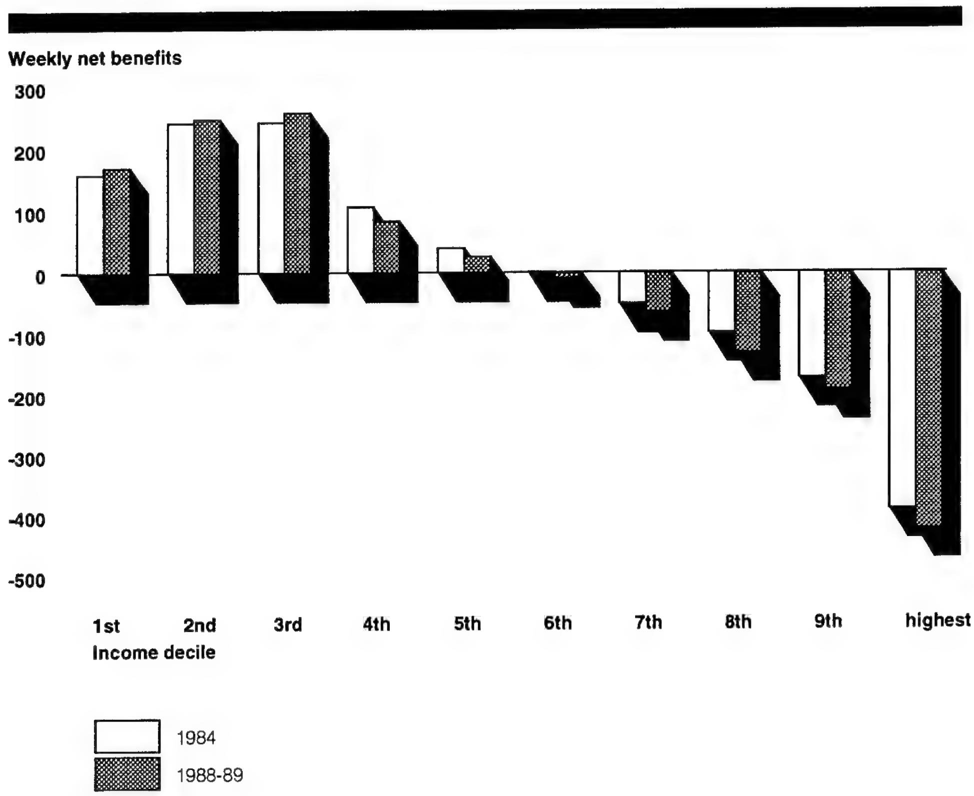
The government made significant spending reductions over the 4 budget years from 1986-87 through 1989-90. In each of these years, growth in total outlays from the previous year was less than the rate of inflation. Measures taken to reduce budget deficits on the spending side included better targeting of benefits, improved administration and eligibility reviews for benefit programs, elimination of some programs, cuts in defense, cuts in capital spending, and reduced payments to the states.

A major package of deficit reduction measures was undertaken in the 1987-88 budget. For this budget, the Treasurer announced a set of measures projected to reduce the 1987-88 Commonwealth budget by over A$4 billion or almost 5 percent of total estimated outlays. The "savings" were divided between expenditure reductions of A$2.6 billion, which included reductions in Commonwealth general purpose payments to the states of A$1 billion and proceeds from the sale of government-owned assets of A$1 billion. The Treasurer stated that these measures reduced growth in total Commonwealth government spending to 2 percent below the rate of inflation, which represented "the biggest fall in 30 years."

Targeting Benefits

One of the goals of the Labor government was to improve targeting of social benefits to those with the greatest financial need and to pay for it by taking away benefits from those deemed less needy. The introduction of means testing for pensions and family allowances, the replacement of unemployment benefits for 16- and 17-year-olds with a job search allowance, narrowing the eligibility requirements for the single parent's pension, and more rigorous eligibility reviews of those receiving benefits were ways in which the Labor government redirected benefits to the most needy. A 1992 study conducted by the Australian Bureau of Statistics provided data on government benefits and taxes on Australian households in 1984 and 1989 that supported the Labor government's claim that better targeting was achieved. Figure I.8 shows how net government benefits increased for families in the first three income deciles and decreased for families in the fourth through tenth income deciles.

Figure I.8: Net Benefits by Income Decile in Australia, 1984 and 1988-89



Note: Net benefits are calculated by subtracting total taxes from total weekly benefits (in 1989 Australian dollars).

Source: The Effects of Government Benefits and Taxes on Household Income, 1988-89, Australian Bureau of Statistics, No. 6537.0.

Officials and experts we interviewed said that the term "entitlements" is not often used to describe social spending programs in Australia. Australian workers do not contribute to a public pension and expect that public old-age pension benefits will be means tested. Government pensions are paid out of the government's general fund.

A brief description of major targeting efforts follows.

- Means testing pension benefits. Soon after coming into power, the Labor government established means testing of pension benefits. In Australia, men become eligible for the old age pension at age 65 and women at age

60. In November 1983, an income test for pensioners was re-established after having been abolished by the Whitlam Labor government 8 years before. In March 1985, an assets test was restored after it had been abolished by the Fraser Liberal government. One or the other of these tests apply so that the pension payable is the lower of the rates determined by the income or assets test. It has been reported that as a result of these changes, the percentage of those eligible who receive pensions dropped from 85.6 percent in 1983 to 75.6 percent in 1991.

- Means testing family allowance benefits. In November 1987, an income test took effect for family allowance benefits. Prior to the enactment of this change, family allowances had been given to anyone with eligible children. At an income level of A$50,000 per year, a family would have its allowance reduced until a family with two eligible children would receive no payment once its income exceeded A$55,156 per year. The narrower targeting of family allowance benefits removed families in the top two income deciles from the rolls. In announcing this change, the Treasurer said, "It is clearly not reasonable that the taxes of low and middle income families should continue to fund benefits for the relatively well-off."
- Unemployment benefits. Changes to the unemployment system starting in January 1988 included replacing unemployment benefits for those under the age of 18 with a job search allowance to reduce the financial incentive for young people to leave the education system, increasing the waiting periods for beneficiaries without dependents under the age of 21, and introducing an assets test for those 25 years and over. The assets test was put in place to help ensure that applicants would have to draw down their own assets before being eligible for public assistance and to ensure that unemployment benefits would not be used as a supplement for early retirement. The Australian Bureau of Statistics estimated that between 1985 and 1989 the percentage of unemployed under the age of 18 receiving unemployment benefits dropped from over 90 percent to 63 percent.
- Sole parent benefit. In the 1987-88 budget the government decided that only single parents with children under the age of 16 would be eligible for the benefit. Previously, the definition of a qualifying child also included dependent full-time students aged 16 to 24 who were not receiving another pension or benefit.

Reductions in Payments to States

Part of the Commonwealth government's strategy to reduce its budget deficit during the mid- and late-1980s was to reduce transfer payments to the states. Between budget years 1986-87 and 1988-89 Commonwealth payments to the states declined. All six Australian states had lower revenues as a percent of gross state product between 1983 and 1990, due in part to reductions in payments from the Commonwealth. Some budget

experts believe that reduced funding to the states resulted in state deficits increasing during the latter half of the 1980s. Some observers told us, however, that reduced payments from the Commonwealth imposed needed fiscal discipline on the states.

When the Commonwealth government cut payments to the states, it reduced the general purpose part of such funding. General purpose payments represent the states' share of general tax revenues and can be used by the states as they see fit. At the same time the Commonwealth was reducing general purpose payments, it was increasing the amount of specific purpose payments. Specific purpose payments are made if the state meets certain conditions and ensures that the funds are used for a specified program. State budget officials we interviewed stated that increases in specific purpose payments did not make up for decreases in general purpose payments because special purpose payments reduce flexibility in state spending, amount to just a pass-through of money to Commonwealth programs, and must be matched with state funds for some programs. State government budget officials also said that the federal government should allow states additional taxing authority to provide more flexibility to meet program demands.

Since the beginning of the Commonwealth, meetings between the State Premiers and the Prime Minister and Cabinet Ministers have been held at least once a year. The Premiers' Conference affords state leaders the opportunity to discuss financial and intergovernmental issues. Held in conjunction with the Premiers' Conference is the Loan Council, in which levels of Commonwealth and state debt are agreed to and the terms and conditions are established. Although these annual meetings provided for direct interaction between the Commonwealth and the states, Commonwealth government decisions to cut general purpose payments to the states were virtually unilateral.

Reductions in Investment

The level of public investment decreased in the last half of the 1980s. One official said that it is always easier to reduce deficits by cutting capital spending rather than cutting spending on operations.[2] He said, however, that capital spending had increased over the 1970s and early 1980s, especially for schools, universities, and electrical power plants.

[2]Australia does not have a capital budget. The budget contains a presentation of capital outlays, but no depreciation charges are calculated.

Revenue Actions

Although spending restraint was the core of the Labor government's deficit reduction efforts, tax reform also played a role. Base broadening measures were taken to increase revenues and included the introduction of a fringe benefits tax and a capital gains tax and the elimination or modification of some tax concessions. On the other side of the equation, however, income tax rates were reduced during the 1980s and a value added tax was discussed but never imposed.

Figure I.4 shows that receipts for all levels of government increased from 31.4 percent of GDP in 1983 to 35.2 percent in 1990. However, figure I.5 shows that revenues at the Commonwealth level rose from 25.3 percent of GDP in 1983 to 27.8 percent in 1986 then decreased to 25.8 percent by 1990.

Asset Sales

In the 1987-88 budget, the government announced that the revenue from the sale of assets would be used to reduce the budget deficit. In 1987-88, revenue from this source was about A$1 billion, and assets sold included part of the Australian Embassy site in Tokyo, the former ambassadorial residence in Paris, and the assets of the National Materials Handling Bureau. In the 1988-89 budget, proceeds from further asset sales for budget years 1988-89 through 1990-91 were estimated to be an additional A$2.5 billion.

Tax Indexation Was Tried, Then Rejected

During the 1975 election campaign, Malcolm Fraser promised to introduce full indexation of the tax system. After winning the election, Fraser's Liberal government indexed the tax system in 1976. However, in 1978, taxes were partially de-indexed in response to continued budget deficits, and, in August 1979, the budget delivered to Parliament abandoned indexation indefinitely. An expert stated that although Prime Minister Fraser had to defend himself against charges of broken promises, the government gave up on indexing taxes because it cost too much and because they had to work too hard to find spending cuts to pay for it. The expert also stated that politicians concluded that indexing tax brackets to adjust for inflation amounted to a tax cut for which they received no political credit.

Tax Reform in 1985 and 1988

Tax reform efforts in 1985 and 1988 were undertaken primarily for structural, rather than budgetary, reasons. In general, tax reform was about improving and rationalizing the tax system; increasing government revenue was only a secondary benefit, largely from reducing tax avoidance under the prior fringe benefits tax.

During the 1984 campaign, Prime Minister Hawke promised that if he were re-elected, the government would hold a tax reform summit. In July 1985, the National Tax Summit was held in Canberra. The discussions on reforming the tax system were based on several principles, which included not increasing the overall tax burden, providing cuts in personal income taxes, reducing tax avoidance and evasion, and making the tax system fairer. Consumption taxes were to be considered, but any new indirect tax had to be acceptable to ACTU and others responsible for wage restraint and have wide support of all summit participants.

Two significant tax changes in 1985 were the introduction of a capital gains tax and of an employer-paid fringe benefits tax. Tax revenue increases from these two changes were estimated to be as much as A$850 million for the 1987-88 budget year, or about 1 percent of total Commonwealth revenues. Government officials told us that prior to reform, the value of fringe benefits was supposed to be reported by each individual taxpayer on a single line of the tax form, but most people did not do so—tax avoidance was a problem. After the 1985 reform, employers were required to pay tax on the value of fringe benefits paid to their employees, including zero or low interest loans; employer-paid health benefits; and employer-provided cars, houses, and parking privileges. An official told us that prior to its passage, there was a great deal of concern over how the fringe benefits tax could devastate the restaurant and car sales industries, but these dire predictions did not come true.

Another significant aspect of tax reform in 1985 was the elimination or reduction of a number of tax expenditures. The deduction for entertainment expenses was eliminated, saving an estimated A$310 million in the 1986-87 budget. Tax concessions for the filmmaking and petroleum industries were reduced as were tax breaks for foreign-sourced income and soil and water conservation.

As set out in the goals for the Tax Summit, the tax reforms in 1985 did not increase the overall tax burden, thanks to substantial personal tax cuts provided in 1986 and 1987 which returned the revenues gained from reforms to the taxpayers. The government also cut tax rates in exchange for real wage reductions from the unions. The tax reform effort in 1988 focused mainly on reducing the corporate tax rate, closing additional tax loopholes, and changing the way some retirement income was taxed.

Among OECD countries, only Australia, the United States, and Switzerland do not impose a value added tax. Imposition of a broad-based goods and

services consumption tax was discussed but not implemented as part of the 1985 tax reforms. The Treasurer supported a proposed 12.5 percent consumption tax to replace the existing wholesale sales tax. However, the consumption tax was not fully supported by the groups at the Tax Summit for various reasons. Some within the Labor Party, ACTU, and welfare groups objected to a consumption tax because it would hit the poor the hardest. Although the business community had in the past indicated support for a consumption tax, it did not support any of the Labor government's proposed options because of the additional costs imposed on business. As a result of the controversy caused by the proposal, the Prime Minister decided to proceed with tax reform without the inclusion of a consumption tax.

Medicare Levy

The introduction of universal health insurance coverage (referred to as "Medicare") in 1983 resulted in Commonwealth outlays for health increasing 40 percent over the previous year. In February 1984, the Labor Government introduced a levy of 1 percent of taxable income to help cover the cost of the new program and then raised the levy to 1.25 percent in December 1986. In July 1993, the levy was raised to 1.4 percent. An official we interviewed said that the Medicare levy did not defray the full cost of the program.

Reaching Agreement

The decision-making approach used by the Labor government during the 1980s has been characterized as "bargained consensus" and as "neo-corporatist." These terms were used to describe the importance the new Labor government placed on achieving some level of consensus with ACTU, business, and other groups upon taking office in 1983. Although it was applied with varying levels of effort and success at different times, consensus and consultation was the Labor government's preferred decision-making approach during the 1980s.

Management and budgetary reform also played a role in Australia's deficit reduction story during the 1980s. The intent of management reforms was to shift the focus away from government inputs to achieving government objectives in an efficient and effective manner. Budgetary reforms were introduced to make budget decisions more transparent and to centralize control of outlay totals. In addition to their stated objectives, these reforms also helped the government promote deficit reduction as part of a larger strategy to make the workings of the government more efficient.

An important aspect of the deficit reduction story during the 1980s and early 1990s was the number of times that the Labor Party was re-elected. After its victory in March 1983, the Labor Party was returned, sometimes narrowly, to office four times—in 1984, 1987, 1990, and 1993. Labor was re-elected in July of 1987, only 2 months after announcing tough measures to reduce the budget deficit by A$4 billion. We were told that the election results indicated that a majority of Australian citizens supported the Labor government's austere fiscal policies and that deficit reduction was not necessarily a political liability. Also, political opposition was somewhat neutralized by the Labor Party's movement into the political middle ground of fiscal restraint.

Consensus Within the Ruling Party

Observers note that the leaders of the Labor Party made philosophical shifts during the 1980s in order to gain and maintain control of the government and to move the Labor Party into the political center. Many in the Labor Party believed that the Party had to overcome a negative fiscal legacy held over from the Whitlam Labor government, which fell in 1975 when the Australian Senate held up government funding. In a philosophical shift some have called "economic rationalism," the Labor government decided to restrain wage growth, let the value of the currency float, deregulate financial markets, reduce trade tariffs, and reduce budget deficits. Prior to winning the national election in 1983, the Labor Party signed an agreement with ACTU that promised a "social wage" that included universal health care and tax cuts in exchange for wage concessions. However, in some policy areas, such as its support of regulated wage settlements, the Labor government did not significantly change its traditional position during the 1980s.

Although its leaders were changing the way the Labor Party approached certain sectors of the economy, consensus within the ruling party and at the Cabinet level was critical. Because the Cabinet and the ruling party can remove the Prime Minister, it was important for the Prime Minister to seek agreement on most issues. The Labor Party had its conservative, moderate, and liberal factions and the interests of all had to be considered under the Labor government's consensus approach to decision-making.

Because difficult budget decisions needed the support of the entire Cabinet and the Parliament, the Labor government relied heavily on the Expenditure Review Committee, a subgroup of Cabinet Ministers, to make decisions on where to make budget cuts. At the beginning of the budget process, the full Cabinet formulated and communicated the government's

overall policies to the spending ministries. However, the Expenditure Review Committee resolved budget conflicts and decided on reductions after consulting with the appropriate Ministers. In this way, departments within government were forced to frame their requirements within the overall framework of fiscal restraint.

According to a former Minister of Finance, the Expenditure Review Committee spent great amounts of time considering how and where to make cuts. He said it made more sense from a policy-making perspective to consider each reduction separately than to rely on an arbitrary mechanism such as across-the-board cuts. Another former government official told us that while across-the-board budget cuts have been considered from time to time in Australia, they have never been used. He said across-the-board cuts would be seen as a surrender of decision-making power and a violation of the agreement between the government and the public on appropriate program spending levels.

It was possible for groups within the party but outside the government to force changes in the budget. For example, in the budget proposed in August 1993, the Labor government tried to eliminate optometry benefits from its health program, thus saving an estimated A$345 million over the next 4 years. However, a group of Labor Party members who were not part of the government (referred to as "backbenchers") disagreed with their own Party's government and forced the government to reinstate the optometry benefits before they would vote to pass the budget. One observer told us that optometry benefits were not the real issue, but the Party caucus used this issue to demand more influence over the policy details.

Opposition's Response Was Muted

Although the opposition party is not formally involved in budget preparation, it can become influential by opposing the ruling party government's fiscal policies, as was shown in the fall of the Labor government in 1975. However, the Liberal Party of Australia, the opposition party during much of the 1980s, was neutralized to some extent by the Labor government's approach to deficit reduction. Opposition members of Parliament we interviewed indicated that the Labor government had taken over the "middle ground" of fiscal restraint in the middle and late 1980s. On the whole, the opposition supported the Labor government's efforts to hold down spending and attempts to better target benefits to the poor, although opposition members argued that spending

should have been cut further. There was disagreement, however, over tax changes such as introduction of the capital gains tax.

Interest Group Involvement

During the 1980s, the Labor Government gained consensus from key interest groups. To obtain this consensus, however, the government had to institute new programs that prompted higher government spending in certain areas. Although the interest group with the most direct influence on the Labor government was ACTU, other groups were consulted periodically.

Unions

As the umbrella organization of Australian unions, ACTU represents a large and centralized interest group. ACTU's membership includes people in roughly the third through the eighth income deciles.

The ACTU leadership took the position in the mid- to late-1980s that deficit reduction was important to Australia's overall economic growth and that only economic growth would increase workers' standard of living over the long term. ACTU leaders were able to convince their constituents to accept real wage reductions. However, the tradeoff was a higher "social wage" in the form of increased government benefits such as universal health care coverage, a new retirement system called superannuation,[3] and tax rate cuts. ACTU also supported the government's introduction of means testing for pensions, the family allowance, and unemployment benefits in order to better target benefits to the needy.

Other Interest Groups

Other interest groups were also consulted on budgetary matters during the 1980s but on a less frequent and direct basis. At the beginning of its tenure in the 1980s, the Labor government convened what was called the National Economic Summit. The Economic Summit was held in April 1983 in Canberra and those in attendance included the Prime Minister and several of his Cabinet, the State Premiers, and leadership from the Council of Local Government Associations, ACTU, the Confederation of Australian Industry, business and professional organizations, and the Australian Council of Social Services.

This widely diverse group came away from the 4-day conference agreeing that, among other things, reducing unemployment and controlling inflation should be high government priorities. The group also agreed that some

[3]Superannuation is the term used for the private pension system covering Australian workers. Improved superannuation was one of the concessions given for wage restraint in 1985 and 1986. In the 1991-92 budget, the Labor government introduced a superannuation guarantee levy on employers that were not complying with requirements to fund private retirement plans.

amount of fiscal stimulus was needed along with an effective policy to control wages and prices. They recommended that a group be formed to represent various interest groups in future consultations with the Labor government. This group was called the Economic Planning Advisory Council (EPAC) and was made up of union, business, government, construction, farming, and social welfare leaders. EPAC continues to offer advice to the government on its policies. Although deficit reduction was not yet a priority in 1983, the Economic Summit conveyed the message that the Labor government was interested in building consensus for its fiscal policies.

The Labor government did not consult with the Australian business community as closely nor as often as it did with ACTU, but business confidence did play a role in deficit reduction during the 1980s. Business leaders were in attendance at the National Economic Summit in 1983, and the business community was familiar with the Prime Minister from his previous position as president of ACTU and member of the Reserve Bank Board. Although business did not always publicly support the Labor government, experts said the business community believed the Labor government offered the best prospects for moderating wage levels. They also pointed out that corporate profitability increased significantly between the years 1983 and 1988.

Building Support for Deficit Reduction

The Labor government used several strategies both to convince the public that deficit reduction was necessary and to make deficit reduction more palatable. These strategies included stressing longer-term economic concerns when asking for short-term sacrifice, offering trade-offs for spending cuts, and instituting management and budgetary reforms to deliver government services in a more efficient and open manner.

Political leadership was also key to successful deficit reduction. The Labor government during the 1980s promoted deficit reduction to the public and followed through once elected. The government convinced the public that failing to act would be worse than accepting actions such as means testing benefits and introducing capital gains and fringe benefits taxes.

Stressing Long-Term Economic Concerns

From the time it took over the government in 1983, the Labor Party, along with government leaders, began to stress longer-term macroeconomic themes such as reducing inflation, creating jobs, and improving international competitiveness. During the 1984 campaign and in the

1985-86 budget, the Labor government made its "trilogy" promise not to increase taxes, government expenditure, or the deficit as a percent of GDP over the life of the next Parliament. The Labor government's stated reason for setting these goals was to make room for expansion of the private sector.

In May 1987, 1 year after the Treasurer made the comment that Australia was in danger of becoming a "banana republic," the Labor government announced a budget containing A$4 billion in deficit reduction measures. In announcing these measures, the government emphasized that weakened trade and economic positions would result in a long-term decline in the Australians' standard of living. Because exports and imports were a significant part of Australia's economy, changes in terms of trade and currency values were perceived by Australians to have immediate effects on their purchasing power and standard of living.

The government effectively linked budget deficit reduction to improving international competitiveness and raising long-term standards of living. Two months later, in July 1987, the Labor government was returned to office in the national election. One official told us that part of the political effectiveness of the Labor government of the 1980s was its ability to tie long-term problems like the budget deficit into short-term crises so that politicians, labor leaders, and the voting public would deal with them.

Interviewees told us that the Labor government turned economic concepts into household words during the 1980s. They said that Australians pay attention to export prices, exchange rates, and other economic indicators. A member of the political opposition told us that many Australians felt "mugged by reality" in the mid-1980s and believed that spending cuts were essential to improving Australia's competitive position in the world.

Changing the Terms of Debate

By focusing on reducing government expenditures and Commonwealth deficits as a percent of GDP, the Labor government changed the way in which interest groups had to frame their claims on budgetary resources. An advocate for the poor, elderly, and disabled told us that his organization published several papers in the late 1980s and early 1990s that put forward a broad agenda, not only in the area of social policy but also in the area of tax reform. By addressing the revenue side of government, the group framed its proposals in terms of how to pay for them. This approach was necessary because the terms of the budget debate had shifted by the late 1980s to focus on ways of reducing the

budget deficit. Arguments for spending on new or improved social programs had to be made in the context of Australia living within its budgetary constraints.

Trade-offs

From the beginning of its tenure in the 1980s, the Labor government seemed to understand that its ability to marshall support for fiscal restraint in certain program areas would be facilitated by making trade-offs in the form of expanded or new benefits in other areas. For example, universal health coverage was introduced in 1983 as part of the "social wage" trade-off for wage moderation, even though economywide wage restraint was not so much a budgetary savings as it was part of the government's effort to improve Australia's competitiveness.

The Labor government was able to initiate new programs during the 1980s, even as overall budgetary spending was being cut. A recent study of Commonwealth budgets between 1983-84 and 1992-93[4] found that, in years in which large-scale savings measures were introduced, substantial spending measures were also introduced, resulting in a kind of churning or re-ordering of policies within and between budgetary functions. One of the possible explanations the author of the study gives for this policy "churning" was related to the government's interaction with interest groups and the inherent difficulty of introducing savings measures over a short period of time. Savings measures that required sacrifice from politically potent interest groups were often combined with what were called expenditure "sweeteners." For example, the government introduced means testing of family allowances in 1987 to remove the wealthy from the roles while it increased family allowance benefits to the poor.

Management and Budget Reform

The Labor government of the 1980s was interested in instituting management and budgetary process reforms. These reforms were intended to make delivery of government service more efficient and to highlight budgetary decisions and make them more transparent. Reforms were also considered by some to be a part of the trade-offs made by the government for deficit reduction. An ACTU leader told us that the Labor Party promised to make the government more efficient prior to taking over in 1983. We were also told by opposition leaders that the minority parties in Parliament generally supported the reforms.

[4]Geoff Dixon, "Managing Budget Outlays 1983-84 to 1992-93," Federalism and the Economy: International, National and State Issues, ed. Brian Galligan (Canberra: Australian National University, 1993).

Governmentwide management reforms included introduction of the Financial Management Improvement Program in 1984, a general restructuring of the government in 1987, and implementation of Program Management and Budgeting in 1988. These reforms were put in place to encourage managerial efficiency and initiative by providing departments with greater discretion over resources. Budgetary reforms under the Financial Management Improvement Program umbrella included introduction of a top-down cost estimating process called the "forward estimates" and establishment of a running costs system for tracking administrative expenses along with the requirement of an annual "efficiency dividend" to improve administrative efficiency.

Some observers credit the management and budget reforms of the 1980s with helping promote and implement deficit reduction. For some, reform was part of the trade-off that the government made in exchange for budget cuts. Brief descriptions of these management and budget reforms follow.

- Forward estimates. After taking office in 1983, the Labor government began to publish "forward estimates"—estimated budget outlays for ongoing programs for over a rolling 3-year period. Forward estimates are outlay estimates based on decisions made in the previous budget year with no future policy changes—similar to the "baseline" in the U.S. budgeting lexicon. Forward estimates are generated by the Department of Finance rather than by each spending department. Prior to the 1983-84 budget, each spending department came up with its own cost estimates, and experts have referred to this practice as "wish list" budgeting. We were told by interviewees that the forward estimates have made the Australian budget process more open and disciplined and have become a powerful tool for holding down spending.
- Running cost system and efficiency dividends. A new system for managing salaries and administrative costs was introduced called the "running cost" system in 1987-88. Its purpose was to provide managers greater flexibility in using administrative funding, including the ability to carry a certain percentage of unspent administrative funds from one fiscal year to the next. The results of the running cost system have been reported to be generally favorable in improving resource management.[5]

In the 1986-87 budget, the government required a savings of 1 percent on administrative expenses and 0.5 percent in salaries to be achieved through increased efficiency. In the 1987-88 budget, the government increased the

[5]For a more detailed discussion, see Management Reforms: Examples of Public and Private Innovations to Improve Service Delivery (GAO/AIMD/GGD-94-90BR, February 11, 1994).

"efficiency dividend" requirement on running costs from 1 percent to 1.25 percent and announced it would reduce the number of staff years over a 2-year period by 3,000 as a result of restructuring departments. Efficiency dividends continue to be required. A senior official stated that the efficiency dividend amounts to an across-the-board cut, but only on running costs, which make up about 10 percent of total spending.

- Government restructuring and program management and budgeting. In 1987, the government reduced the number of departments from 28 to 18 and generally realigned them into ministerial "portfolios." Observers said this change resulted in better integration and more effective management.

  Program Management and Budgeting was also instituted in 1987. This program was intended to complement reforms under the Financial Management Improvement Program with focus on defining government policy objectives, establishing program structures to facilitate the achievement of the objectives, and determining appropriate performance measures.

Budget Deficits During the 1990s

Beginning with the 1991-92 budget year, the Commonwealth budget slipped back into deficit of 2.4 percent of GDP and a year later the deficit had reached 3.6 percent. According to OECD calculations, roughly half of the overall public sector deficit in 1992 was due to the cyclical effects of a recession during 1991. The remaining deficit can be attributed to structural imbalances that have developed since the late 1980s. Experts told us that the Labor government had cut spending as far as it was willing to, given its priorities, and that it had started to give back benefits such as new child care payments and further tax cuts. There was also some agreement that budget balancing action in the future would need to focus on increasing revenues as well as cutting spending. At the time the 1993-94 budget was printed, the government planned to bring the budget deficit down to 1 percent of GDP by fiscal year 1996-97.

Conclusion

Deficit reduction in Australia during the 1980s was the result of both policy decisions and economic growth. The Labor government opened up the Australian economy to more international influence by floating the currency, reducing tariffs, and deregulating financial markets. In 1986, the government pointed to the fall in commodity prices and exchange rates as an economic crisis that needed to be addressed through tighter fiscal policy. The government promoted its plan of austerity on the grounds that

it would improve Australians' long-term standard of living. Structural changes were made so that when Australia's economy rebounded strongly in the latter half of the 1980s, budget deficits were reduced quickly and surpluses were achieved. Although deficits have re-emerged in the 1990s, several observers stated that the deficit reduction actions and reforms of the 1980s imposed an increased level of discipline on the Australian budget process.

Canada

The general government[1] deficit in Canada and both net and gross public debt are currently among the highest of the G-7 countries.[2] In 1993, the federal government deficit was 4.6 percent of GDP. The federal government in Canada has taken many actions on both the revenue and expenditure sides of the budget since the mid-1980s in an attempt to reduce the deficit, and benefited from strong economic growth following the recession of 1982. The government's measures have not succeeded in reversing the cycle of deficits, debt, and high interest costs that have become a part of the Canadian economy.

Background

Canada is a federal system composed of a central government, 10 provincial governments, and 2 territories. It has a parliamentary system of government, which is composed of the Senate and the House of Commons. The Prime Minister is the leader of the political party that has the majority of seats in the House of Commons. Senators are appointed by the Prime Minister, while House of Commons members are elected by popular vote. The provincial legislatures are composed of a single house, the legislative assembly, which is also elected by popular vote. At the federal level, the Liberal party won general elections in 1968, 1972, 1974, and—following a brief minority Progressive Conservative administration—in 1980. The Progressive Conservative party captured the majority in general elections in 1984 and 1988, but the Liberals returned to power in 1993.

Responsibilities of Different Levels of Government

Constitutionally, Canada has two levels of government, the federal and the provincial. The municipal, or local level, falls under the jurisdiction of the provincial government. The responsibilities of the two levels of government are detailed in table II.1. Provinces levy sales taxes but over the years, due to the heavy social responsibility carried by the provinces, a variety of federal-provincial agreements that distribute federal revenues to the provinces, have also developed.

[1]OECD defines general government as all levels of government combined, including social security trust funds.

[2]The G-7 includes Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

Table II.1: Responsibilities of the Two Levels of Canadian Government

Responsibilities of the federal government	Responsibilities of the provincial governments
Defense Foreign aid Unemployment insurance Old-age pensions Family allowances (subsequently converted to a child tax benefit)	Health care Education Social assistance

Transfers to the Provinces

The three major federal transfer programs to the provinces are (1) Established Programs Financing (EPF), (2) the Canadian Assistance Plan (CAP), and (3) the fiscal equalization program. In budget year 1992-93, the total of all transfer payments to other levels of government equaled approximately 18 percent of total federal budgetary expenditures.

Through EPF, the federal government provides financial assistance on an equal per capita basis to all of the provinces for health care and post-secondary education. The growth in EPF payments was originally tied to the growth rate of the economy, but the increase was capped below the growth rate several times during the 1980s.

Through CAP, the federal government provides contributions for income support and other social services for those in need. Under the original CAP plan, federal payments equaled 50 percent of eligible provincial expenditures, and the payment was open-ended. In 1990, the federal government placed a 5 percent cap on the annual rate of growth of CAP payments to the three wealthiest provinces—Alberta, British Columbia, and Ontario.

To ensure that provincial governments can provide comparable levels of public services at reasonably comparable levels of taxation, the federal government is responsible for provincial equalization. Provinces with below-standard fiscal capacities are provided payments to bring them up to a five-province standard based on the economies of Ontario, British Columbia, Quebec, Saskatchewan, and Manitoba.

The Budget Process

Canada has a budget process that is relatively closed to the public as well as to Members of Parliament. The Cabinet makes decisions on government priorities for the upcoming year and must come to consensus on the overall size of the budget and on the amount of dollar changes that will be needed to reach that goal. Once the Cabinet reaches agreement on

revenue and expenditure targets, however, the budget work is turned over to the Ministry of Finance, the Treasury Board, the Privy Council Office, and the Office of the Prime Minister. The Ministry of Finance has primary responsibility for preparing the budget, the Treasury Board monitors the management of the budget and serves as a budget scorekeeper, and the Privy Council facilitates the passage of proposals through the Cabinet committees and the full Cabinet.

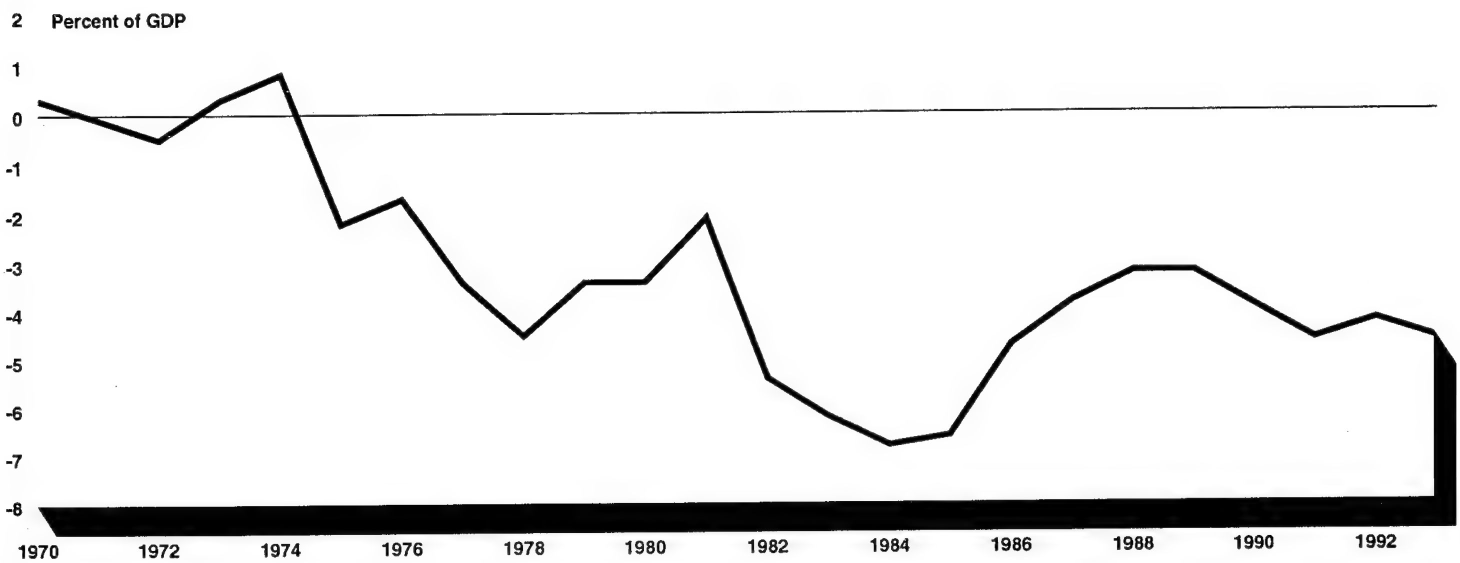
The full Cabinet does not know the outcome of the budget until the day it is released. In the past, by tradition, if any budget material was leaked in advance, the Minister of Finance was required to resign. The closed nature of the budget process has elicited considerable criticism, and recent governments in Canada have supported proposals to open up the process to more public scrutiny and involvement.

The Canadian budget is composed of statutory and nonstatutory items. Programs which receive continuing authority, and which cannot be changed without Parliamentary approval, such as interest on public debt, and most transfers to provinces and individuals, are examples of statutory programs and are similar to mandatory programs in the U.S. budget. In 1992, statutory expenditures accounted for more than two-thirds of total net annual expenditures. Programs that do not receive continuing authority and that do not require Parliamentary approval before the Ministry of Finance or the Treasury Board can change their level of funding are nonstatutory and are similar to discretionary programs in the United States. The estimates for program changes that do not require statutory approval, however, usually do not change once submitted by the Board of Estimates.

Size and Causes of the Deficit

The government was able to decrease but not eliminate the federal budget deficit between 1984 and 1988, reducing it from 6.6 percent to 3.2 percent of GDP, as illustrated in figure II.1.

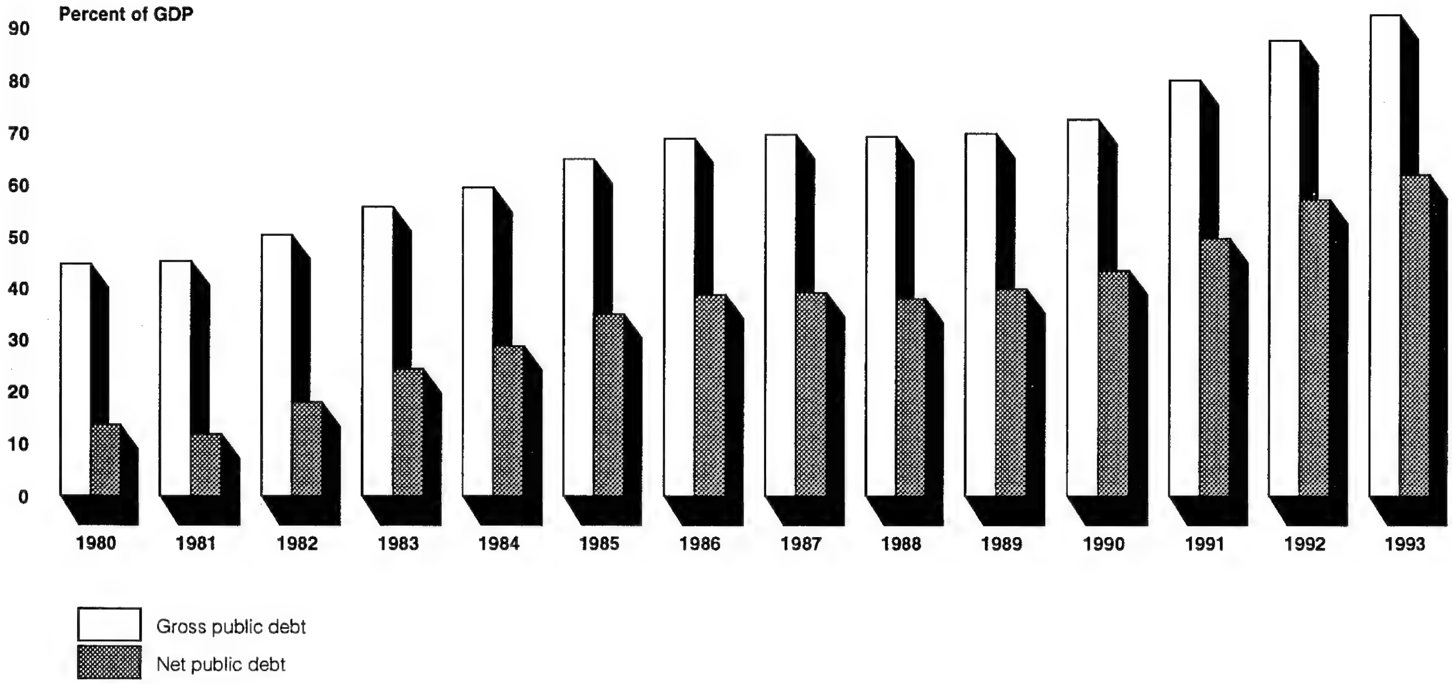
Figure II.1: Federal Government Financial Balance in Canada, 1970-1993



Source: Economic and Fiscal Reference Tables, Department of Finance, Canada, September 1994.

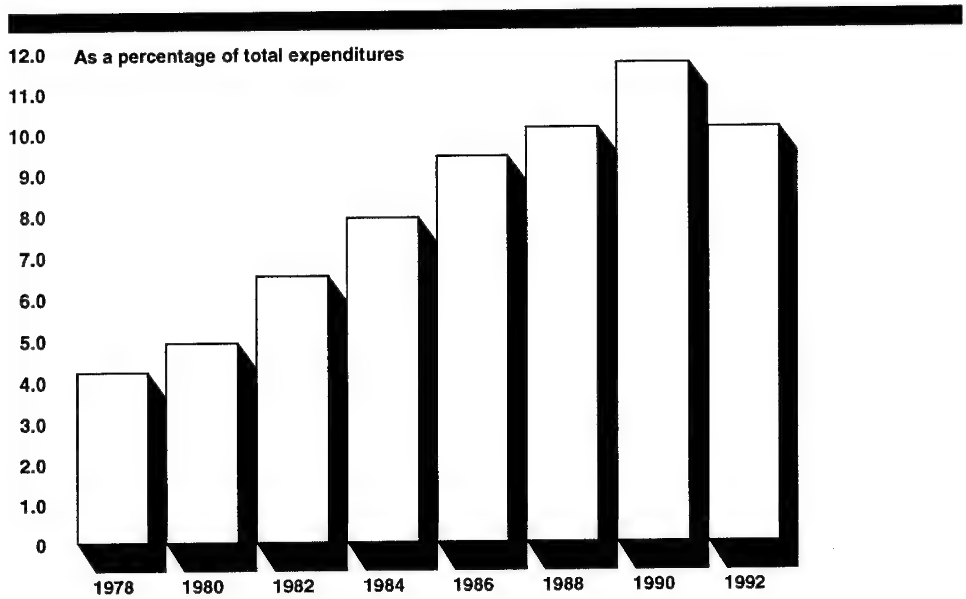
Since 1988, however, the federal budget deficit has been increasing, and as of 1993, it had risen to 4.6 percent of GDP. Provincial government deficits were relatively small throughout the 1980s but quickly expanded at the beginning of the 1990s. Both federal and provincial debt and deficits in Canada have a significant impact on the national economy. By 1993, the general government deficit had risen to 6.8 percent of GDP, and both net and gross general government debt were the second highest among the G-7 countries at 61.9 percent and 92.3 percent of GDP, respectively. Figure II.2 shows the growth in net and gross debt since 1980, while figure II.3 illustrates the change in debt-related interest costs.

Figure II.2: General Government Gross and Net Debt in Canada, 1980-1993



Source: OECD Economic Outlook, #55.

Figure II.3: General Government Net Debt Interest Payments in Canada, 1978-1992

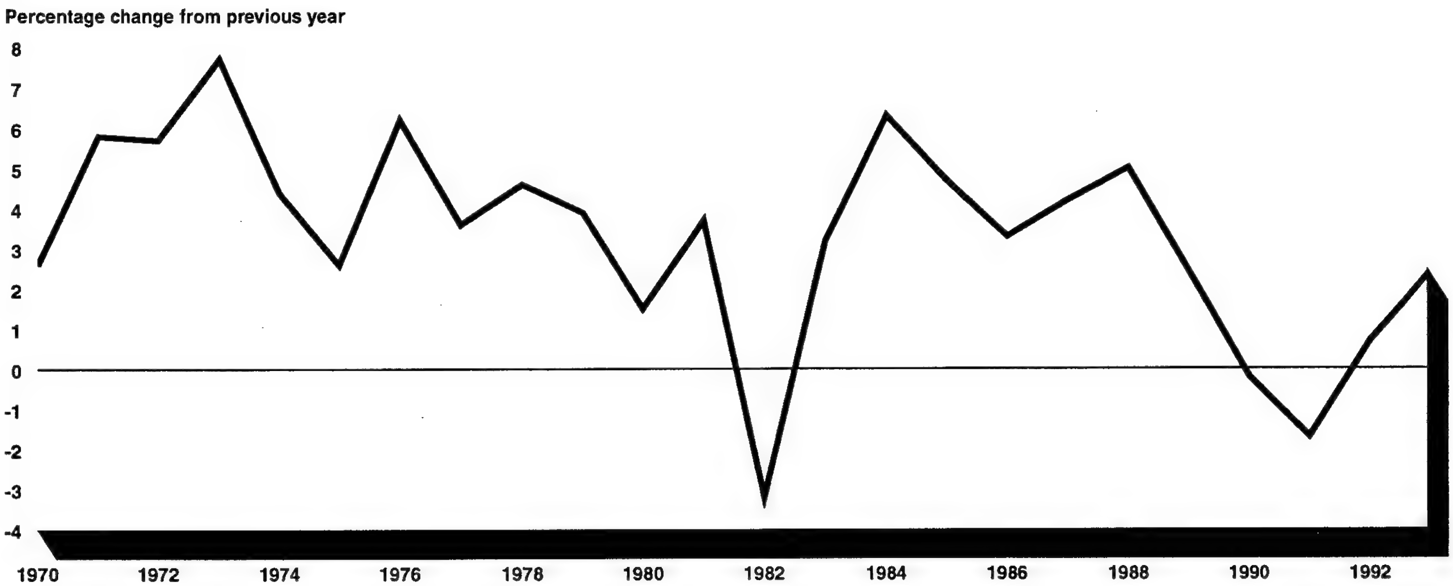


Source: OECD Economic Outlook, #55.

Economic factors as well as internal policy decisions led to annual deficits in Canada beginning in 1975. This imbalance between revenues and expenditures occurred due to a slowdown in economic growth, which occurred at the same time that program spending increased, and because social programs as well as the federal income tax were fully indexed to inflation.

Following 1973, and the shock to the world economy due to the rise in oil prices, the real rate of economic growth began to slow in Canada. A severe recession that began in 1981 accelerated this slowdown. Figure II.4 shows real GDP growth between 1971 and 1993. According to experts, the government also overestimated future growth in the economy and continued to implement fiscal policies based on an anticipated higher rate of growth.

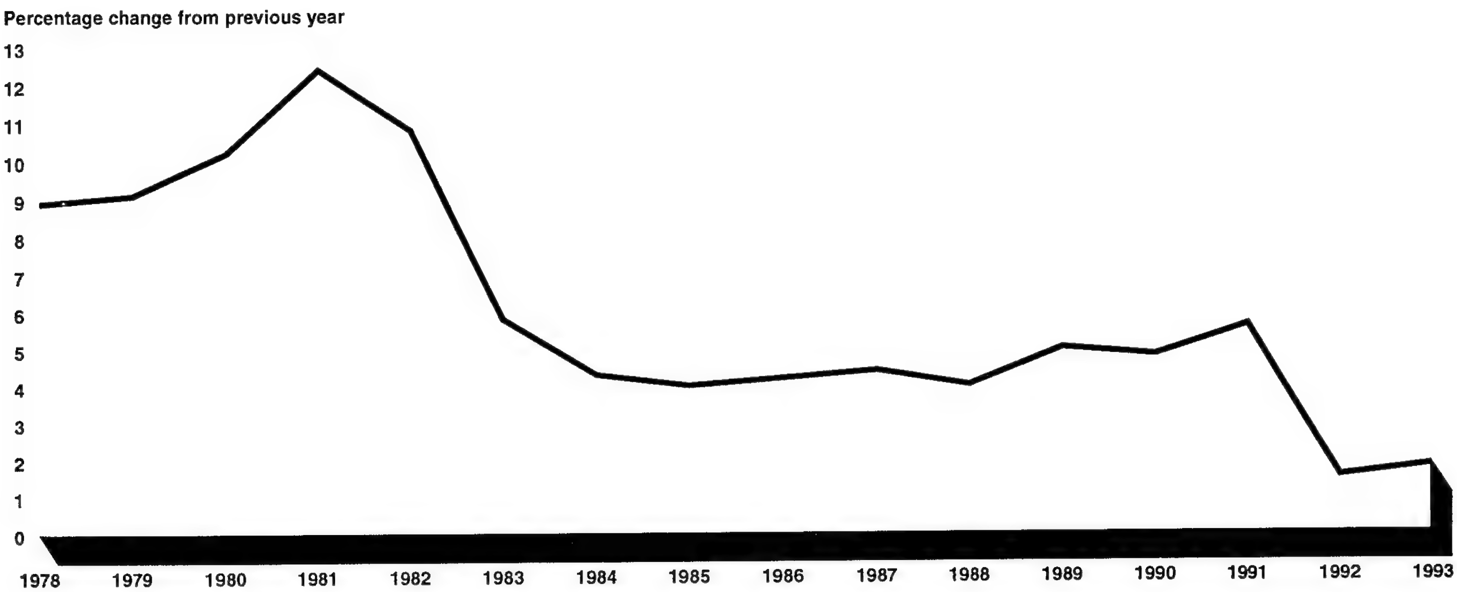
Figure II.4: Real GDP Growth in Canada, 1970-1993



Source: OECD Economic Outlook, #55 and #47.

Following World War II, the Canadian government committed itself to social programs on a scale previously unknown in that country. Since that time, Canada has developed a strong social welfare system, which includes old-age pensions, family benefits, and universal healthcare. Beginning in the mid-1970s, social programs were indexed for inflation, which created a built-in rather than a periodic increase in program spending. In 1966-67, social expenditures were 8.6 percent of gross national product (GNP), while by 1987-88, they had risen to 17.1 percent. Inflation was high up to the mid-1980s but was reduced to about 4 percent by 1984. Figure II.5 illustrates the levels of inflation between 1978 and 1993.

Figure II.5: Consumer Price Inflation in Canada, 1978-1993



Source: OECD Economic Outlook, #55.

At the same time that expenditures were increasing in the second half of the 1970s, revenues were decreasing. This decrease in revenues was due not only to the declining economic growth rate but was also a result of significant changes to the indexation of taxes. The personal income tax brackets and exemptions were indexed to inflation in 1974. This reduced revenues because the government could no longer benefit from the "inflation tax" that resulted from people moving to higher tax brackets. During the same period, the government increased tax expenditures, and reduced the sales tax rates and base.

Impetus for Reducing the Deficit

The federal government in Canada undertook deficit reduction in the 1980s to reduce the growing debt and to bolster both domestic and international investor confidence in its economy. Canada has never experienced an economic crisis in which the government was unable to sell its bonds, but the country has experienced currency depreciations,

high interest rates, and lowered bond ratings at both the federal and provincial levels.

Concerns About the Effect of Debt on the Economy

In 1984, the Canadian government acted to reduce the fiscal deficit in response to concerns over the growing public debt and its adverse effects on the economy. The Progressive Conservative government came into power at the end of 1984 with a platform that included reducing the public sector deficits and debt, and reducing government intervention in the economy. The Progressive Conservatives expressed concern, in particular, over the adverse effects of debt on domestic and international investor confidence in the Canadian economy. The Progressive Conservative Finance Minister, who was strongly committed to deficit reduction, illustrated these concerns in the Progressive Conservatives' platform paper, A New Direction for Canada: An Agenda for Economic Renewal.

Increased Debt Led to Increased External Borrowing

The large deficits in Canada contributed to increased foreign borrowing, which in turn increased the country's vulnerability to foreign markets and currency instability. Borrowing abroad results in a flow of interest payments from the country. Interviewees said that such borrowing places a large amount of debt in the hands of foreigners, whose actions can have a significant effect on the value of the currency and on interest rates. Canada has experienced several currency depreciations over the past decade. In 1986, the effective exchange rate[3] in Canada fell from 92.7 to 86.7, a 6.5 percent drop, and in 1993, it fell from 93.4 to 88.4, a 5.4 percent drop. The 1986 budget contained more revenue measures than expenditure constraints, including a new temporary federal income surcharge, added partially in response to the fall of the Canadian dollar. This "temporary" surcharge was subsequently raised as part of the 1989 budget. According to one expert, the tax changes in 1986 were accepted because of a sense of crisis on the part of the public.

Despite the government's commitment to reduce Canada's reliance on foreign borrowing, Canada's foreign debt has more than doubled since the early 1980s, and in 1994, Canada had the highest level of foreign-held debt relative to GDP of all of the G-7 countries.[4] Experts have stated that Canada's continued dependence on foreign capital has left its markets exposed to sudden shifts in investor confidence, which has depressed the

[3]OECD calculates the effective exchange rate with a base of 1991 = 100.

[4]This foreign debt includes debt issued by governments and private corporations and direct foreign investment in Canadian companies.

currency and caused interest rates to rise. The large size of the debt itself has also contributed to higher interest rates as both domestic and foreign lenders require higher rates of return to support the increased risk created by the rising level of debt. Figure II.6 shows the change in both short- and long-term interest rates between 1980 and 1993.

The Bank of Canada has maintained a tight monetary policy, which has resulted in low levels of inflation. When inflation rose again in the late 1980s, the government set targets aimed at reducing inflation to 3 percent by the end of 1992, and to less than 2 percent by the middle of the decade. These targets have not only been met, but inflation has been lower than required. According to the Ministry of Finance, this low level of inflation has contributed to a recent decrease in interest rates and debt-related interest costs, as illustrated in figures II.3 and II.6.

Figure II.6: Short- and Long-Term Interest Rates in Canada, 1980-1993

Source: OECD Economic Outlook, #55.

Deficit Reduction Actions

The federal government has taken a variety of measures to reduce the deficit since 1984, on both the expenditure and revenue sides of the budget. The government succeeded in constraining expenditure growth, but this was not sufficient to eliminate the deficit and reduce the overall debt.

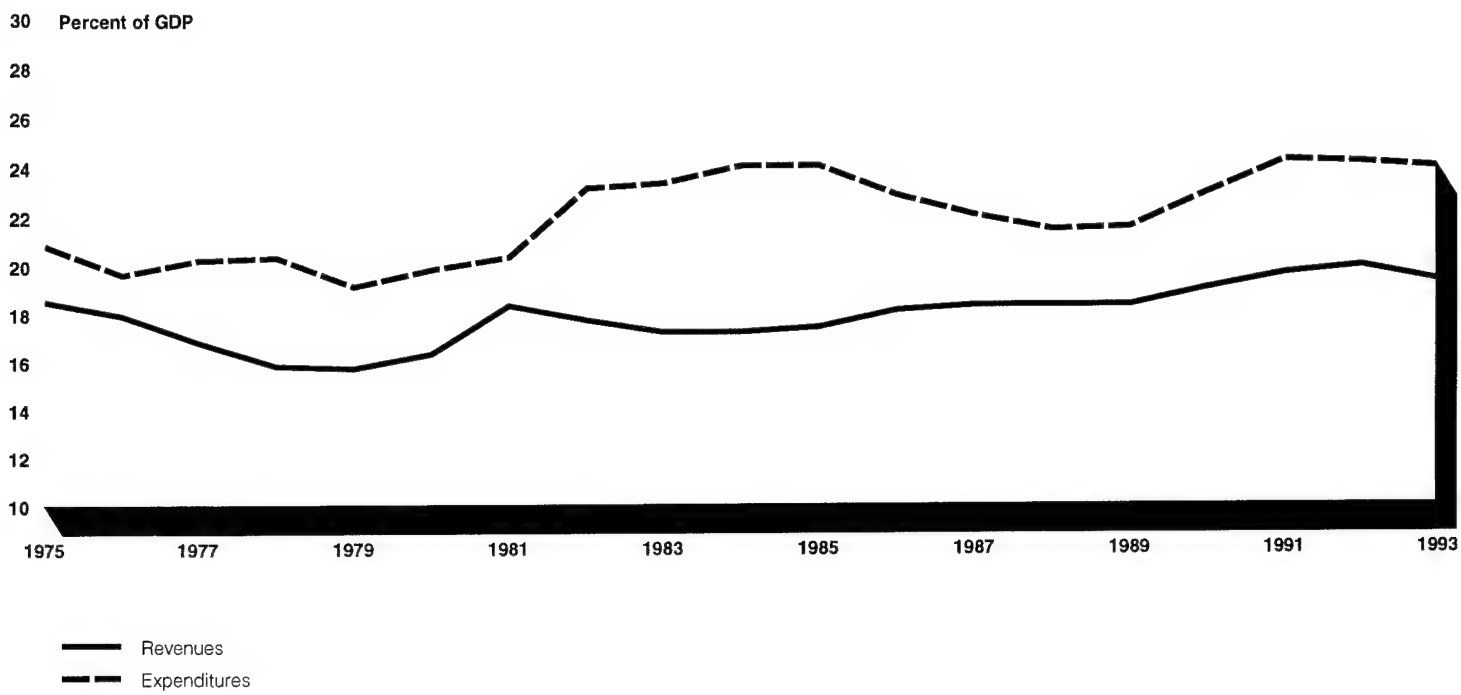
The most systematic deficit reduction efforts did not begin until the Progressive Conservative government came into power in 1984. To control inflation in the early 1980s, the Liberal government under Prime Minister Pierre Trudeau had introduced a system of wage limits, as well as imposed ceilings on the indexing factors for a number of transfer programs. However, in 1982, the Liberal government responded to the worsening recession with an expansionary fiscal policy. The Liberal government was successful in reducing inflationary pressures, but the wage controls came to an end shortly after the Conservative government took over from the Liberals in 1984.

At the end of 1984, the Progressive Conservatives came into office on a platform of reducing government intervention in the economy and curtailing the fiscal deficit. The government quickly outlined a strategy to streamline the government and reduce the deficit. The major part of deficit reduction was to come from expenditure cuts and cost reduction from improved efficiency, and from reducing the size of government.

The Finance Minister, Michael Wilson, stated that the immediate goal was to reduce the deficit through expenditure reductions and not through major tax increases. According to the Ministry of Finance, restraint on program spending held annual average spending growth to 3.9 percent between 1984-85 and 1991-92, while average inflation during this period was 4.6 percent. On the revenue side, the government increased taxes between 1984 and 1992. According to one economist, taxes on the household sector[5] increased by 6.7 percent of GDP between 1984 and 1991, a larger increase in the tax burden than in any of the other G-7 countries. This growth came largely from increases in federal commodity taxes and income surtaxes. Between 1985 and 1991, total tax revenue excluding social security rose by 3 percentage points of GDP. Figure II.7 illustrates the change in federal government expenditures and revenues between 1975 and 1993. The federal government budget deficit fell from 6.6 percent of GDP in 1985 to 3.2 percent of GDP in 1988.

[5]The household sector is defined to include taxes on individuals, social security contributions, and indirect taxes.

Figure II.7: Federal Government Revenues and Expenditures in Canada, 1975-1993



Source: Economic and Fiscal Reference Tables, Department of Finance, Canada, September 1994.

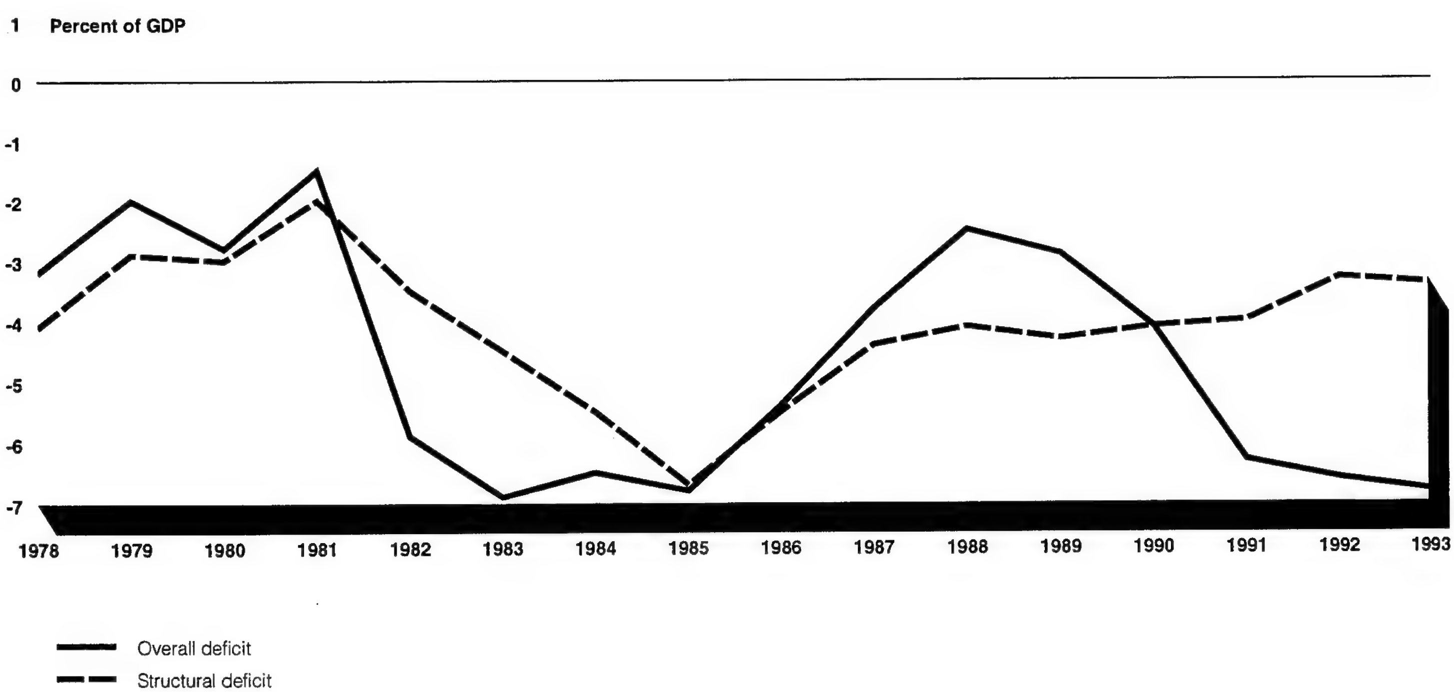
Economic growth was very strong in Canada after the country recovered from the 1981-82 recession. Despite the deficit reduction actions taken by the government, a variety of experts stated that Canada missed an opportunity by not implementing greater austerity measures in a period of economic growth. OECD stated that a more rapid pace of fiscal consolidation would have been more desirable given the strong economic environment.

The Progressive Conservative government succeeded in making reductions to the deficit in its first several years in office, but cutting became more difficult, according to one expert, as the public in general and interest groups in particular became more adroit at dealing with the federal government. According to another expert, the approaching election of 1988 also contributed to a weakening of stringent fiscal

measures. Both the federal and the general government deficit began to increase after 1988.

In its 1990 budget, the government introduced the Expenditure Control Plan, which grouped together and systematized many of the government's deficit reduction measures. In 1991, the government implemented the Spending Control Plan, which placed ceilings on overall program spending for 1991-92 through 1995-96 at the levels projected in the 1991 budget. The government's deficit reduction measures since the mid-1980s have resulted in improvements to the structural component of the general government deficit, which is the component of the deficit that increases or decreases based on direct policy actions as opposed to the effects of the business cycle. The structural deficit was approximately 6.7 percent of GDP in 1985, while it fell to 3.4 percent of GDP in 1993, but the overall general government deficit and debt have continued to rise. (See figure II.8.)

Figure II.8: General Government Overall and Structural Deficits in Canada, 1978-1993



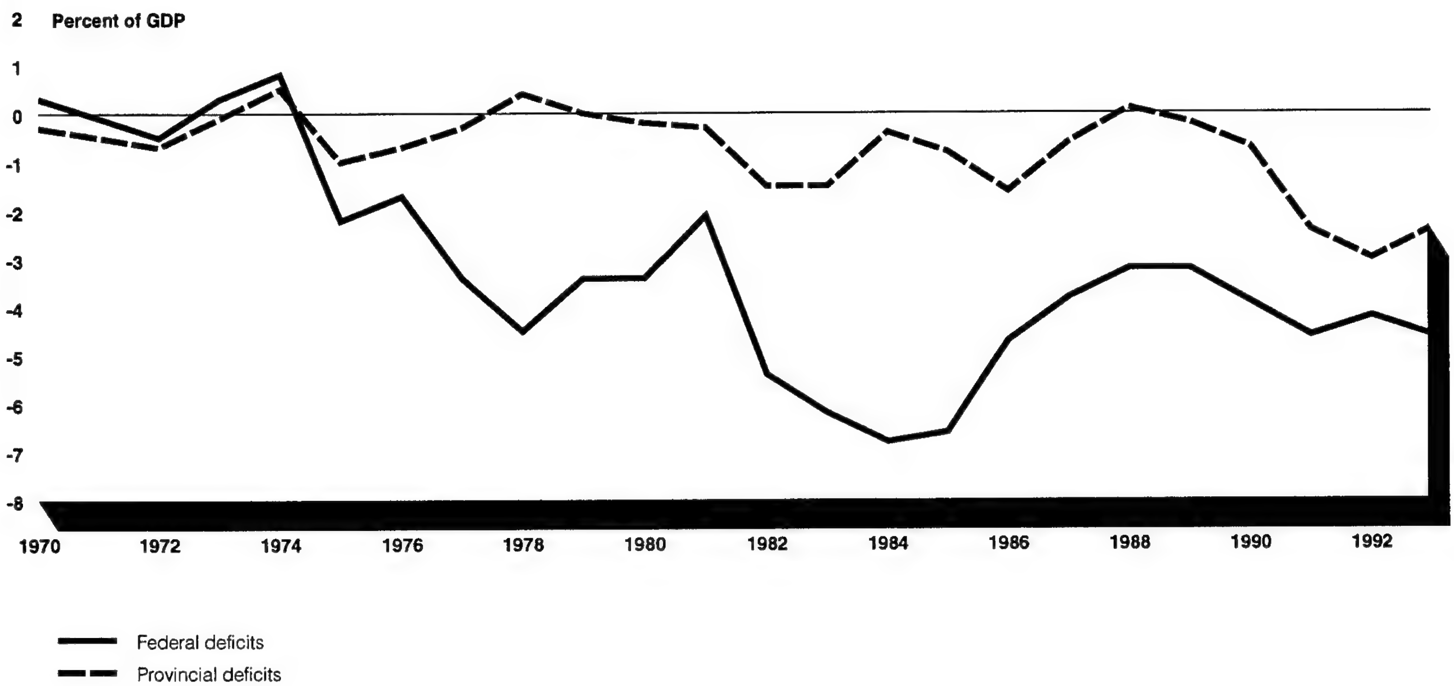
Source: OECD Economic Outlook, #55.

Spending Actions

Expenditure constraint at the federal level helped restrain the rate of spending growth. The government accomplished this restraint by reducing the size of the public workforce and constraining public wage increases, limiting discretionary spending on government programs and operations, and modifying the indexation of benefit and transfer programs.

- Reduced size and wages of public workforce. Public service employment was reduced by approximately 4 percent between 1984-85 and 1990-91. The Ministry of Finance estimates the savings at Can$1.5 billion. In 1991, wage increases for public service employees were frozen and limited to no more than 3 percent for 1992 and 1993.
- Reduced foreign assistance and defense. The two primary discretionary programs in Canada are defense and foreign aid. Cash payments for Official Development Assistance (foreign aid) were reduced in 1985 through 1989 and program growth was restricted beginning in 1991. The Ministry of Finance estimates savings on foreign assistance between 1985-86 and 1991-92 at Can$5 billion. Reductions in real growth were made in the defense program in 1986, and in 1989, reductions in spending were enacted. Annual caps were placed on spending growth in 1990-91. In 1992, the Ministry of Finance projected savings of more than Can$3 billion since 1985-86.
- Modified the indexing of benefits. The government modified the indexation formulas for several social programs. In 1985, the government limited the indexation to the amount by which inflation exceeded 3 percent for Family Allowances, a universal program for families with children.
- Targeted program benefits. Family Allowances were ultimately eliminated and replaced with the Child Tax Benefit (CTB). The Family Allowance program was a universal spending program, while CTB is a means-tested tax credit.
- Shift in costs to provinces. The government limited the growth of the provincial transfer program, EPF (health care and post-secondary education), several times during the 1980s and capped the growth of CAP (welfare) in 1990. Provincial deficits as a whole remained relatively small throughout the 1980s but quickly expanded at the beginning of the 1990s. Comparative information on federal and provincial financial deficits and surpluses between 1970 and 1993 is presented in figure II.9. In 1980, transfers to other levels of government equaled 20.9 percent of total federal expenditures; by 1993, transfers had been reduced to 18.3 percent of federal expenditures.

Figure II.9: Federal and Provincial Financial Balances in Canada, 1970-1993



Source: Economic and Fiscal Reference Tables, Department of Finance, Canada, September 1994.

Some experts stated that because transfer programs were previously open-ended, provinces may have had little incentive to control costs before limits were imposed. The limits placed on CAP and EPF require the provinces to either constrain provincial expenditures, borrow additional funds, or pay more for services out of their own budgets. One expert also stated that the provinces are fiscally healthier than the federal government and are better prepared to grow out of their deficits. As a result of these reductions, however, deficits and debt at the provincial level have increased significantly, and provincial bond ratings have been lowered several times during the 1990s.

Since the early 1970s, health care costs in Canada have not been as steep as in the United States. Yet, Canada ranks second highest among OECD countries, behind the United States, in health expenditures per capita. In

1971, Canada and the United States spent about the same share of GNP on health care. By 1989, the Canadian share of health care spending was 8.9 percent of GNP, while the U.S. share was 11.6 percent. The federal government used EPF reductions to help control the central government deficit, but as health care is primarily a provincial responsibility, these costs have continued to contribute to the provincial budget deficits.

Since 1990, some of the provincial governments have taken significant fiscal restraint measures. For example, Ontario has reduced health care spending from 10 percent growth a year in the 1980s to 1 percent in 1993. Universal health care is still legislatively mandated, but in Ontario health care spending is no longer open-ended, and the Ministry of Health negotiates with the medical community regarding what will and will not be covered. Ontario has also negotiated a social contract with its public sector workers, and employees agreed to accept salary reductions and furloughs.

- Reduced capital expenditures. The federal government reduced capital expenditures through reductions to the capital budgets of nondefense related departments in the federal government.
- Implemented systematic deficit reduction programs. In 1990, the government implemented a broadbased restraint program, called the Expenditure Control Plan, which reduced, froze, or limited spending growth in every area except major transfers to persons. Major transfers to persons include elderly benefits, family benefits, veterans' allowances and pensions, unemployment insurance benefits, and equalization and Canada Assistance Plan transfers. Many of the exempted social programs, however, are subject to reductions which lie outside of the plan—for example, the tax on elderly benefits, which is described below. The control program was originally planned to last 2 years but was extended to 5 years in the 1991 budget.

In 1992, the government implemented the Spending Control Act, which placed legislated limits on total program spending. The act stipulates that noninterest spending, with a few limited exceptions, cannot exceed the levels projected in the 1991 budget through 1995-96. According to the Spending Control Act, if a program expenditure rises above its projection for economic or policy reasons, it has to be offset by reductions elsewhere and cannot be funded through increased taxes or increased borrowing. Spending that was subject to the Spending Control Act exceeded the limit during 1992-93. The act specifies, however, that underspending in 1 year may be carried forward to offset overspending in other years. In 1991-92,

spending subject to control was sufficiently below the limit to offset the overage in 1992-93.

One expert stated that it is possible that the Spending Control Act may not be renewed after 1995. Some experts believe that the ceilings are too high and do not force restraint. Others said that tough spending decisions in Canada are made by elected officials rather than by a spending control mechanism.

- Reformed the unemployment insurance program. High unemployment has been a recurring problem in Canada: the unemployment rate in Canada ranged from 10.4 percent to 11.8 percent between 1982 and 1985, has not been below 7.5 percent since that period, and rose again above 11 percent during the 1990-91 recession. Prior to reform in 1990, revenues for the unemployment insurance program in Canada came from a combination of employer and employee premiums and contributions from the federal government. In 1990, reforms ended the government's direct contribution and the program is now funded entirely from employer and employee premiums. The government will now only contribute to unemployment insurance financing in a severe economic downturn when it would be difficult to raise premiums. While the program is on a payroll basis, the general public appears to view the unemployment insurance premiums as a tax and is concerned about the size of the program, the generosity of the benefits, and the cost to the taxpayer.

Until recently, the expenditure and revenue activities of the unemployment insurance program were not part of the general budget, but operated through an off-budget fund. Today, the general budget reflects both the gross outlays and offsetting revenues for the program.

Revenue Actions

The federal government took a variety of actions on the revenue side of the budget as well, beginning in 1984, ranging from partially de-indexing income tax schedules and exemptions to implementing a deficit-neutral consumption tax. Revenues as a share of GDP in Canada declined slightly between 1974 and 1981, following the tax measures introduced in the 1970s. Total revenues began to show steady improvement, however, at the beginning of the 1980s.

Tax Reform

The government undertook substantial tax reforms in the 1980s. In 1985, the government modified the indexation formula for the personal income tax to take advantage of revenue increases due to inflation. Personal

income tax schedules and exemptions were partially de-indexed and are now adjusted only when inflation exceeds 3 percent.

In 1988, the government reduced top personal income tax rates, replaced tax exemptions with credits, reduced corporate tax rates, and reduced or eliminated a variety of investment allowances. The tax reforms were intended to be revenue neutral, while increasing the efficiency of the tax system.

The government reformed indirect taxes in 1991 by replacing the manufacturers' sales tax with a 7 percent value added tax called the Goods and Services Tax (GST). The GST is imposed at all levels of production, and the consumer pays the last stage of it at the cash register. The manufacturers' sales tax caused distortions and erosion of the tax base, and its multiple rate structure increased administrative costs. The government believed the GST would broaden the tax base, enhance efficiency gains by reducing price distortions, and lower administrative costs. The GST is broadly based, but certain items are exempt, such as basic groceries and medical supplies.

Public dissatisfaction with the GST has been evident. One reason for the dissatisfaction is the contrast with the manufacturers' sales tax. This sales tax was an invisible tax on manufactured goods, which means that the tax was incorporated into the final sales price whereas the GST is a visible tax. Because the federal VAT is not integrated with provincial retail taxes, except in the province of Quebec, the tax appears on sales receipts in addition to the provincial sales taxes. According to current and former public officials, political leaders wanted visibility to prove to the public that they were not planning to raise rates in the future.

Poor timing also contributed to public dissatisfaction with the GST. Originally the federal government intended to implement the GST at the same time it reduced income taxes. However, income taxes were reduced in 1988 but the GST was not implemented until 1991. Because of the delay in implementing the GST, and because of the invisibility of the prior manufacturers' sales tax, the public perceived the GST as a new tax. One official stated that the government did not make clear that the tax was designed to replace revenues lost by reductions in the income tax, nor did it adequately promote the benefits of the GST.

Many Canadians believe that tax evasion is becoming a serious issue and perceive the underground economy to be growing. Public officials as well

as the press have stated that a large part of this evasion is due to the introduction of the GST. The GST also levies a tax on services, which appears to have created an incentive for people to pay cash under the table. This results in a loss to the government of the income tax that would have been levied on these payments as well as the loss of the GST.

Net GST revenues, along with the proceeds from privatization and gifts to the Crown earmarked to debt reduction, are credited to the Debt Servicing and Reduction Account. This account, established through legislation, and introduced in the 1991 budget, is used to pay interest on the public debt and to ultimately pay down the national debt if budget surplus is achieved.

Tax Increases

Some public policy analysts and economists characterized the tax increases as quite significant during the period the Progressive Conservatives were in office. Successive increases were made in the rate of the manufacturers' sales tax, which was at 13.5 percent before it was replaced by the GST in 1991. Tax brackets and exemptions were partially de-indexed. Excise taxes on gasoline, tobacco and alcohol were increased, and a federal income tax surcharge was imposed on personal income. Between 1985 and 1991, total tax revenue excluding social security rose by 3 percentage points of GDP in Canada.

Taxation of Benefits

The government, in effect, ended the universality of Old Age Security (OAS), a noncontributory pension program, at the end of the 1980s. In Canada, pensioners become eligible at age 65 to receive both OAS benefits and benefits from the Canada Pension Plan (CPP), a wage-based contributory pension plan. In 1989, the Canadian government introduced a "claw-back" tax on OAS benefits. This meant seniors were required to repay a portion of their OAS pension for every dollar of net income above a certain threshold. In 1991, seniors with net incomes of Can$50,000 or less did not pay the claw-back; those with net income between Can$50,000 and Can$76,332 made a partial repayment; and seniors with net incomes above Can$76,332 paid the entire amount of their OAS benefits back to the federal government.

Privatization

Between 1984 and 1992, the government privatized or dissolved over 20 government-owned commercial enterprises (Crown corporations), but, according to officials, the revenue and savings realized through privatization have not been significant in terms of deficit reduction. Since 1990, by legislation, proceeds from privatization are to be credited to the Debt Servicing and Reduction Account, but experts with whom we spoke stated that the sale of government-owned corporations has been primarily

to improve efficiency and stop the drain of finances that the Crown corporations have incurred, rather than to significantly increase federal revenues.

Possible Reasons Why Canada Has Been Unable to Reach Balance

Although the Progressive Conservatives came into office on a platform that emphasized deficit reduction, the government did not succeed in controlling the deficit. The Progressive Conservative government undertook many deficit reduction measures, but public officials and policy analysts have stated that the government did not effectively promote many of its policies to the public, and allowed other provincial and constituent priorities to supersede its efforts. Some of the possible reasons why the Canadian government may not have been able to achieve sustained deficit reduction are explored in the following sections.

- Deficit reduction was difficult to sustain. Current and former officials told us that although the Progressive Conservative party came into office on a platform to reduce the deficit, there was a lack of unanimity on the part of the Mulroney government regarding deficit reduction. The government also backed off from making hard spending reduction decisions, for example, in the areas of de-indexing old-age pensions and carrying out unemployment reforms in the 1980s that affected the provinces. Officials also told us that the Progressive Conservative government initially undertook reductions that could be easily accomplished and that did not involve eliminating or restructuring programs. An example of the government's somewhat limited commitment to reducing the deficit can be seen in the disbanding of the Expenditure Review Committee, which was created in 1989 to prioritize expenditures and ensure that expenditure control contributed to deficit reduction. The ministers on the committee were reluctant to cut programs, however, particularly those that affected their departments or regions, and the committee was ultimately disbanded.
- The two levels of government have had difficulty reaching consensus. Canada is essentially a regional system, and the two levels of government are often driven by different incentives. A fragmented political structure has developed in response to this in which it is extremely difficult to reach consensus.

Canada is a loose federation composed of 10 provinces and 2 territories that are relatively autonomous in their areas of jurisdiction. Policy analysts stated that provinces in Canada tend to be concerned about their own internal issues, sometimes to the detriment of Canada as a whole. For

example, when the unemployment insurance system, a federal program, was modified in 1990 to make it more difficult to qualify for benefits, provincial governments were not pleased because more people were then able to qualify for social welfare, which is a provincial responsibility. The federal Cabinet usually contains one Minister from each of the provinces, which often makes reaching consensus very difficult.

Canada is officially a bilingual country. Canada is composed of two linguistic groups, the French and the English speakers. Approximately 25 percent of the population is French speaking and is largely concentrated in the province of Quebec. The Separatist party in the French-speaking province of Quebec held and lost a referendum in 1980 on the sovereignty of Quebec, and the Separatist Party won the majority in the 1994 elections in Quebec. Experts told us that due to Canadian political fragility, the federal government has been somewhat reluctant to take difficult deficit reduction measures that might affect the provinces. Quebec is a large spending region that receives significant transfer payments from the federal government, but currently, according to experts, political leaders have been hesitant to challenge the spending practices of the province.

- Prolonged deficits have increased the level of debt and the size of the "interest bite," making future deficit reduction even more difficult. The continuous deficits in Canada have placed the country in a "vicious circle" of deficits, debt, and high interest costs. Achieving budget surplus allows a country to reduce its public debt, and ultimately its interest costs, freeing up budgetary resources for other spending priorities. In Canada, the prolonged deficits have accumulated into a massive public debt, which has resulted in large interest costs that in turn increase the annual deficit. This problem was exacerbated in the 1980s and early 1990s by interest rates that were exceptionally high and which exceeded the annual rate of growth in the economy.

To illustrate the size of the interest payments on the debt, the Canadian government uses a measurement it calls the "interest bite" to express interest payments as a percentage of revenues.[6] This measure reflects the amount of money Canadian taxpayers give to the government in the form of taxes and user charges. In 1992, the interest bite for the Canadian federal government was 33 percent, up from 13 percent in 1968. This means that in 1992, for every dollar collected, 33 cents went towards the interest payment on the debt.

[6]Report of the Auditor General of Canada to the House of Commons, 1993.

- Special interests have played a small but growing role in opposing elements of deficit reduction. Interest groups in Canada often come together for specific issues, then disband after accomplishing their specific agenda. These groups, however, can be quite vocal and visible. For example, when the federal government tried to partially de-index benefits for the elderly in 1985, senior citizens staged a well-publicized demonstration on Parliament Hill, compelling Prime Minister Mulroney to back down. These old-age benefits remain fully indexed for inflation, but they are now taxed, as described previously. Some Canadians believed that this episode illustrated that the Prime Minister could not be counted on to make unpopular reductions, and that interest groups could make a difference.

The Current Situation

Prime Minister Mulroney's public approval ratings were low at the beginning of the 1990s. Experts have stated that the GST was one of the primary factors leading to Mulroney's low public approval, but during the previous decade, Canadians had also endured expenditure restraint and tax increases while receiving few additional benefits in return. Mulroney stepped down early from his position as Prime Minister and was replaced by Kim Campbell, who served as Prime Minister for only 4 months. The Liberal government won a majority in the federal election held in October 1993, and Jean Chretien became the new prime minister. The Progressive Conservative party not only lost its majority standing but only retained two seats in the House of Commons.

During the campaign, the Liberals promised to reduce the deficit to 3 percent of GDP by 1996-97 and strongly emphasized job creation, while the Progressive Conservatives ran on a platform to reduce the deficit to zero within 5 years. Once in power, the Liberals were faced with a growing fiscal deficit, due primarily to a weak economy in which revenues had leveled out, but expenditures had not. The Liberals quickly promoted deficit reduction to a higher level of priority. The Chretien government initiated a number of reviews calling for fundamental change, including a review of the social welfare system, a review of the GST, and a review of the basic roles and responsibilities of the federal and provincial governments.

Conclusion

The Canadian government has made structural improvement to the general government deficit based on policy initiatives begun in the mid-1980s. The actions taken by the government have not, however,

succeeded in controlling the deficit, and Canada remains enmeshed in a cycle of deficits, debt, and high interest costs. Tax rates are high in Canada, particularly in relationship to the United States, and many experts believe that tax evasion is becoming a serious issue. The Chretien government has begun a thorough review of programs and governmental activities, which is intended to be a precursor to considering fundamental structural changes.

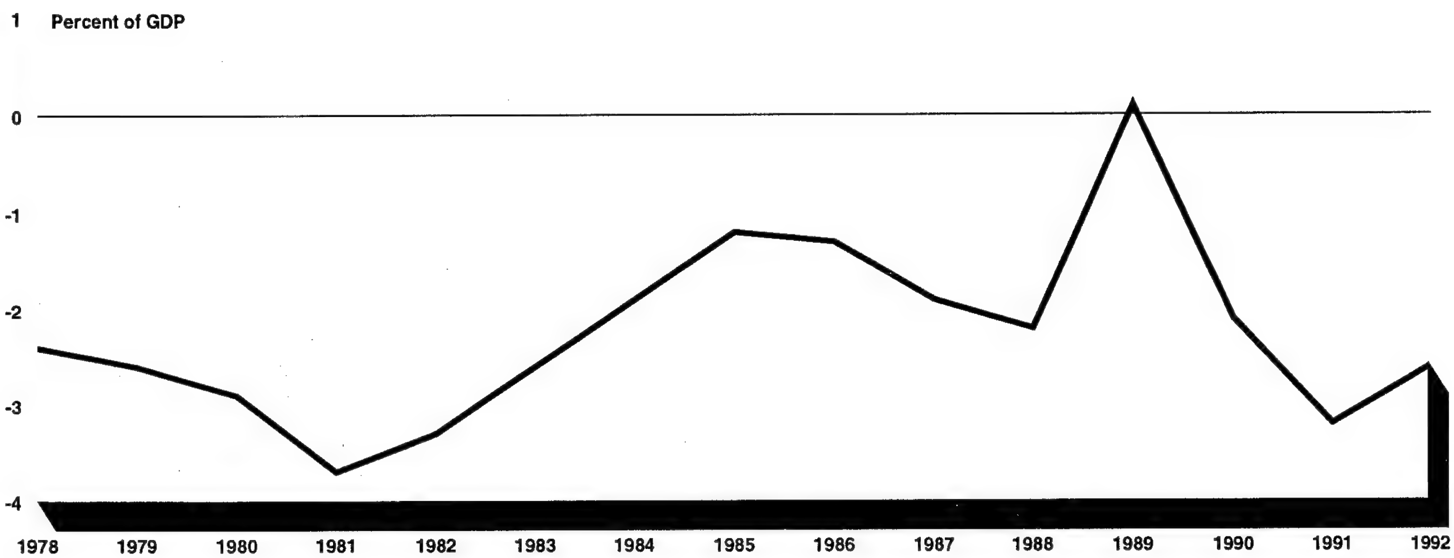
Federal Republic of Germany

During the 1980s, deficit reduction became a national priority in Germany as many government leaders, experts, and citizens became concerned with rising levels of government debt and the increasing portion of the budget needed to service the debt. Those concerned worried that the mounting debt would limit the federal government's budgetary and political maneuverability to implement new policies and respond to emerging social and economic needs.

A new center-right coalition government took power in 1982, pledging to reduce the budget deficit. Figure III.1 shows that the federal government reduced the public sector deficit[1] over the next 7 years. Figure III.2 shows that deficit reduction was achieved by restraining expenditure growth. To reduce public sector spending, the federal government secured the cooperation of state and local governments to contain the growth in expenditure to no more than 3 percent per year over the next several years. The government's tax reform in the latter half of the 1980s was done for reasons other than reducing the deficit and focused on reducing income tax rates. However, the government's deficit reduction effort benefited from economic growth in the second half of the 1980s as revenue levels were bolstered by a strong economy.

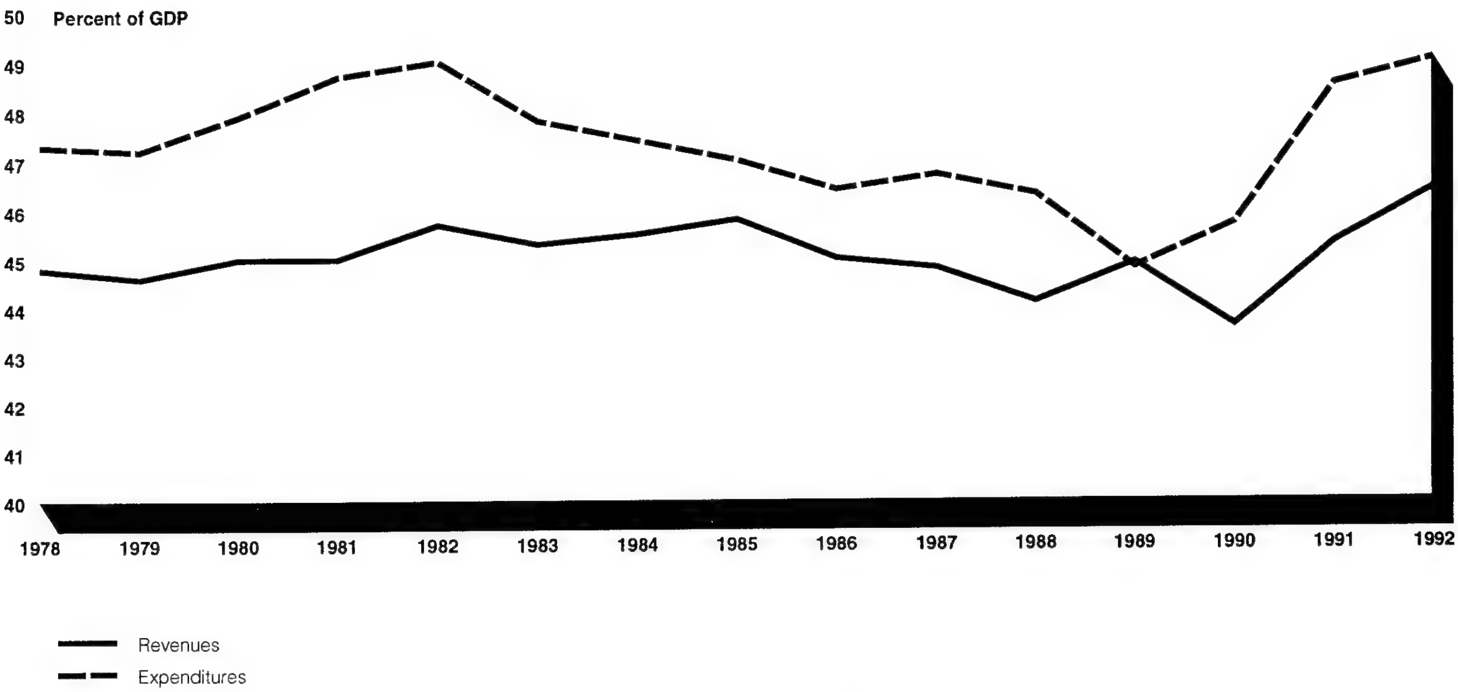
[1]The Organization for Economic Cooperation and Development defines general government as all levels of government combined, including social security arrangements imposed, controlled, or financed by the government.

Figure III.1: General Government Financial Balance in Germany, 1978-1992



Source: OECD Economic Outlook, #55.

Figure III.2: General Government Revenues and Expenditures in Germany, 1978-1992



Source: OECD Economic Outlook, #55.

Background

The 1949 German Constitution, or "Basic Law," established a political system composed of federal, state,[2] and local governments. The popularly elected lower house of the federal Parliament is called the Bundestag. The Bundestag elects the Federal Chancellor, who exercises executive powers along with the Federal Ministers. The upper house is called the Federal Council or the Bundesrat. Its members are appointed by the governments of each state.

Since 1949, the West German federal government has been formed by coalitions of the four largest political parties—the Christian Democratic Union (CDU), the Social Democratic Party (SPD), the Free Democratic Party (FDP), and the Christian Social Union (CSU). Table III.1 provides information on the ruling coalitions from 1949 through 1994. The coalition

[2]In October 1990, the 5 states of the German Democratic Republic (East Germany) united with the 11 states of the Federal Republic of Germany (West Germany). Unless otherwise stated, references and figures concerning the states refer to the 11 western states.

government of Chancellor Kohl replaced the government of Chancellor Schmidt in 1982 when the Free Democrats aligned themselves with the Christian Democrats and the Christian Social Union in a vote of no confidence that brought down the government. The CDU/CSU-FDP coalition won a general election in 1983 and was re-elected in 1986 and 1990.

Table III.1: Coalition Governments in Germany, 1949 to 1994

Time period	Coalition government	Political characterization
1949-1966	CDU/CSU-FDP	Center-right
1966-1969	"Grand Coalition" of CDU/CSU-SPD	Center
1969-1982	SPD-FDP	Center-left
1982-1994	CDU/CSU-FDP	Center-right

Budget Process

Although the German federal budget is created by the ruling party government and normally approved by Parliament, the federal budget process has built-in mechanisms for ensuring consensus. One important mechanism is the requirement that the Bundesrat approve the annual budget. The Constitution requires Bundesrat approval for all tax proposals and for spending that affects state responsibilities such as education, crime, housing, and family allowances. Since the Bundesrat is made up of representatives of state governments, the interests of the states are given much weight in budget deliberations. In addition to providing the states with a way to influence the federal budget, the Bundesrat can also give the opposition party a chance to make budgetary changes if it controls the upper house. If the Bundestag and Bundesrat cannot agree on budgetary changes, a mediation committee composed of members of both bodies meets to work out a compromise.

Another way in which consensus is introduced into the budget process is through the recommendations of the Financial Planning Council. The Council, which includes Finance Ministers from the state and federal levels and local representatives, meets periodically to recommend courses of action during federal budget preparation to coordinate federal, state, and local plans. The Chancellor and the Ministry of Finance must take into account the recommendations of the advisory Financial Planning Council although they are not bound by its suggestions. In the early 1980s, the Financial Planning Council recommended that annual growth in overall government spending should be limited to no more than 3 percent.

The need for consensus on deficit reduction policy also existed within the federal government itself. While the Chancellor of the ruling coalition that enacted most of the deficit reduction policies in the 1980s had a majority in the Bundestag and Bundesrat, that was not always sufficient to ensure his policies would prevail. A study of German politics stressed that government by coalition forces the German Chancellor to seek consensus for economic and other policies from Cabinet Ministers and coalition partners.[3]

Impact of Social Security on the Budget

The extensive social security system needed to meet the requirement in the Basic Law that each citizen be guaranteed a minimum standard of living, with state assistance if necessary, has a major impact on the budget. According to OECD data, the German social security system accounted for between 24 and 27 percent of total GDP in the 1980s and is supported both by insurance funds and by government expenditures. The three basic insurance programs for unemployment, retirement pensions, and health care are funded equally by employee and employer contributions. All employees are required to belong to the unemployment and pension insurance funds, and 90 percent of all workers contribute to the state health insurance plan. Spending for social benefits is the largest expenditure category in the federal budget by far, comprising about 37 percent of the total 1993 budget of DM458 billion.

Responsibilities of Different Levels of Government

The German government's efforts to control budget deficits in the 1980s required the central, state, and local levels to coordinate their deficit reduction efforts. The financial autonomy granted each level of government under the Basic Law meant that this coordination required a high degree of consensus between the different levels. The Constitution allocates and mixes responsibilities, tax authority, and expenditures at all three levels. The federal government's responsibilities include defense and transportation. The states' responsibilities include police, education, and welfare. Local governments are responsible for most public infrastructure investment and public utilities. Major sources of governmental revenue include the income tax, the value added tax and other consumption taxes, and business taxes. These revenues are shared among the three levels of government.

[3] Peter J. Katzenstein, Policy and Politics in West Germany: The Growth of a Semisovereign State (Philadelphia: Temple University Press, 1987).

Impetus for Reducing the Deficit

The West German economy grew steadily and its federal government generally ran small deficits or small surpluses in its budgets between 1949 and 1969. However, beginning in the late 1960s, changing economic and political circumstances resulted in budget deficits, which generally increased between 1974 and 1981. When the center-left SPD-FDP coalition government assumed power in 1969, it increased spending in an effort to stabilize the economy and to expand the role of the state. Expansionary fiscal policies, combined with the recessionary effects of two oil price shocks during the 1970s, led to large increases in public sector deficits between 1974 and 1981. Deficits were also compounded by all three levels of government basing their budget plans on overly optimistic growth expectations.

In the early 1980s, the federal government abandoned its approach to countering recession through fiscal expansion and adopted a medium-term strategy advocated since the mid-1970s by the German Board (or Council) of Experts for the Assessment of Overall Economic Trends.[4] This approach focused on reducing budget deficits as important for combating inflation, promoting long-term economic growth, and providing the federal government with more fiscal room to respond to emerging needs.

Growth of Government Spending During the 1970s

In 1969, a center-left government, the Social Democratic Party in coalition with its Free Democratic Party partners, took control of the government.[5] They implemented policies that increased government expenditure from 39.1 percent of GNP to 48 percent over the 1970s, and increased social security expenditures from about 11.2 percent of GNP in 1970 to 15.8 percent in 1979. The government expanded welfare benefits and public employment, boosted investment, and increased educational spending. It introduced a child benefit program that provided universal payments for families, regardless of income levels. Between 1970 and 1980, the government increased public investment and increased the total public workforce (excluding military) by nearly one quarter to 3.17 million.

According to a German government document, budgetary policy was used in the 1970s to "steer demand by increasing intervention in the workings of

[4]The Board (commonly referred to as the Council of Economic Experts or the "Five Wise Men") consisted of a top economist from five of the six leading German economic institutes. The Council was established in 1967 to provide economic forecast reports to the Ministry of Finance every year. This report and the Minister's response form the starting point for the Bundestag's yearly budget debates.

[5]The coalition remained in power from 1969 to 1982 under the leadership of Chancellors Brandt (1969-1974) and Schmidt (1974-1982).

the economy" and "to keep aggregate demand at an adequate level, thus assuring high growth rates."[6] This policy required increasingly high levels of government spending as the economy entered recessions after both the 1973 and 1979 oil price shocks. Economic growth rates slowed, and unemployment and inflation increased during the decade.

At the end of the 1970s, the other G-7 countries (the United States, Canada, Japan, France, the United Kingdom, and Italy) encouraged Germany to increase its public investment in the belief that if the United States, Japan, and Germany stimulated their economies, worldwide economic growth would result. Germany agreed to expansionary fiscal measures equivalent to 1 percent of GNP. German funding commitments to the European Community also grew in the 1970s, from about 2.5 percent of general government revenue to about 3.5 percent by 1987.

The deficit problem was also aggravated by the tendency of central, regional, and local governments to base budget estimates on the relatively higher average economic growth rates of the late 1960s and early 1970s. When actual growth slowed and revenues fell short of projections, deficits grew.

By the end of the 1970s, the deficit and the interest payments on the debt had increased to the point that government leaders felt they had to reverse the losses in fiscal and political "maneuverability" (that is, the ability to fund their social and economic programs and stabilize the economy). Furthermore, unemployment and inflation had reached crisis levels in the view of the public, who were sensitive to Germany's history of hyperinflation and economic turmoil in the first half of the 20th century.

The SPD-FDP government began to implement policies designed to reduce the deficit and restore political maneuverability. However, deficits continued to grow and the Christian Democrats made them a key issue in their successful effort to gain control of the government in 1982. The new CDU/CSU-FDP coalition government won the general election in 1983 pledging to reduce the deficit and stating that deficit reduction was a necessary precondition to controlling inflation, implementing tax reform, and reducing the government's role in the economy.

Leaders Shaped Concerns

By the early 1980s, a number of economic pressures were beginning to force the SPD-led federal government to change its economic policies and

[6] The German Budgetary System, Ministry of Finance, 1991.

give budget deficit reduction greater priority. These factors included the recession induced by the second oil shock, high inflation, high unemployment, high interest costs, and a general loss of political "maneuverability." Government officials told us that although public sector deficits in the early 1980s were lower as a share of GDP in Germany than deficits in other countries, the German public was very concerned about deteriorating economic conditions which included recession and high inflation and unemployment levels. Episodes of hyperinflation and economic collapse earlier in the century greatly contributed to the public's sensitivity about the government's financial problems. One German political party official stated that this sensitivity was the most important aspect of Germany's fiscal policy. Furthermore, the independent and influential Bundesbank was calling for deficit reduction to put public finance back on a sound footing in order to restore confidence in the economy.

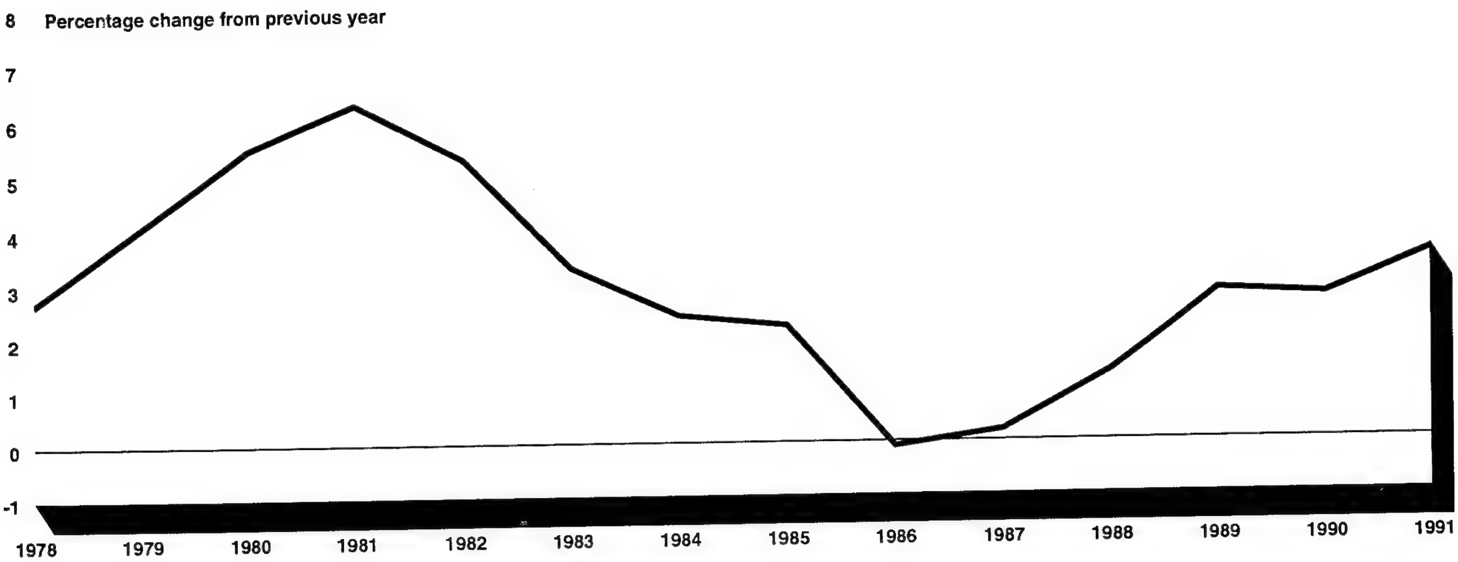
The Second Oil Shock and Recession

Government officials and experts told us that the increase in oil prices in 1979 was a catalyst for a change in the early 1980s. This second oil price shock of the 1970s triggered a recession in 1981. The government at first underestimated the extent to which the sudden upsurge in the price of oil affected the economy and continued to overestimate economic growth rates in their budget planning. The government also attempted to reverse the downturn by using the same countercyclical and demand-led approach it had used during the recession following the previous oil shock. The general government deficit grew from 2.4 percent of GDP in 1978 to 3.7 percent in 1981.

Inflation and Unemployment

Inflation and unemployment were serious concerns in the late 1970s and early 1980s. During this time, inflation had been increasing, peaking at 6.3 percent in 1981. Unemployment had increased from 1.6 percent in 1974 to 5.9 percent in 1982, and in 1981 unemployment had passed the significant barrier of 1 million persons. Although the German inflation rate was somewhat less than the rates being experienced in most other western economies at that time, it seemed high to the inflation-sensitive German public. In the year before the 1983 election, inflation remained at the relatively high level of 5.3 percent, before dropping to 2.4 percent in 1984. (See figure III.3.)

Figure III.3: Consumer Price Inflation in Germany, 1978-1991



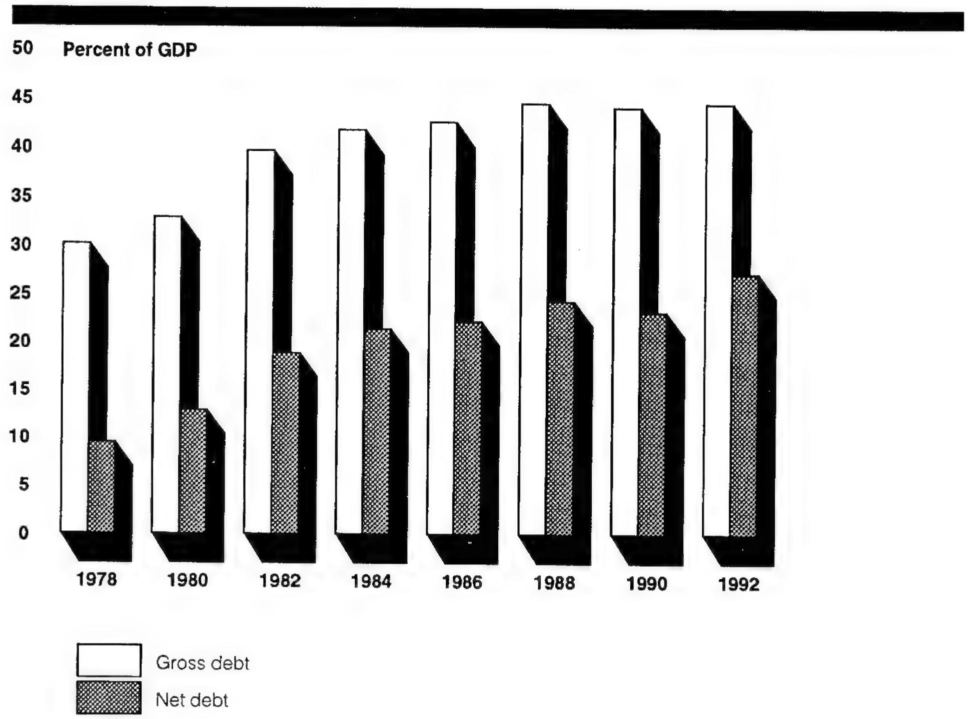
Source: OECD Economic Outlook, #55.

Reduced Fiscal and Political Maneuverability Resulting From Increasing Interest Payments

German government officials agreed that the loss of fiscal and political "maneuverability" was one of the most significant factors in prompting the government to pursue budget deficit reduction as a top priority—although this effect was not perceived widely outside of economic and government circles. The "maneuverability effect" was the most immediate problem posed by the debt burden because it seriously limited the political system's ability to respond to public needs, such as public investment and social policy initiatives.

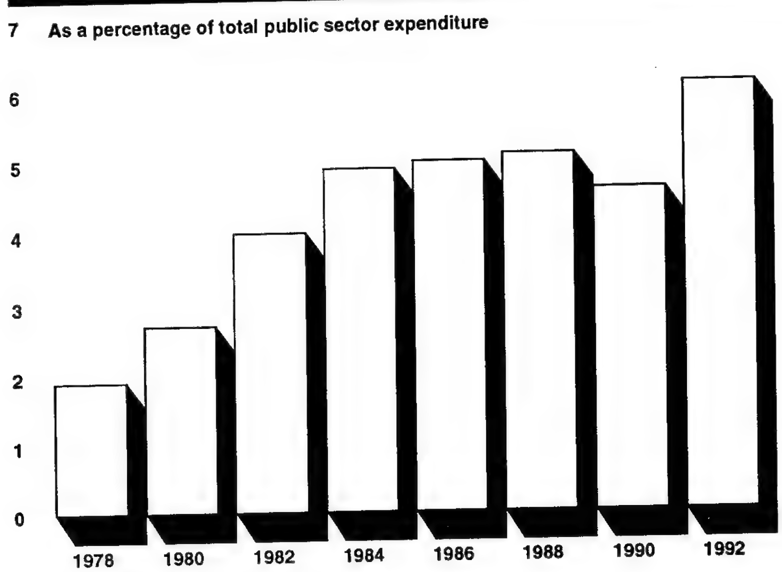
The effects of high deficits began to make themselves felt in the early 1980s, when the compounding interest on the debt accumulated. The public debt more than tripled from DM125.9 billion in 1970 to DM468.8 billion by 1980, and the annual debt service became a deficit driver. Increases in long-term interest rates during early 1980 and 1981 put pressure on the financial system and raised fears that the higher rates would crowd out private spending and investment.

Figure III.4: General Government Gross and Net Debt in Germany, 1978-1992



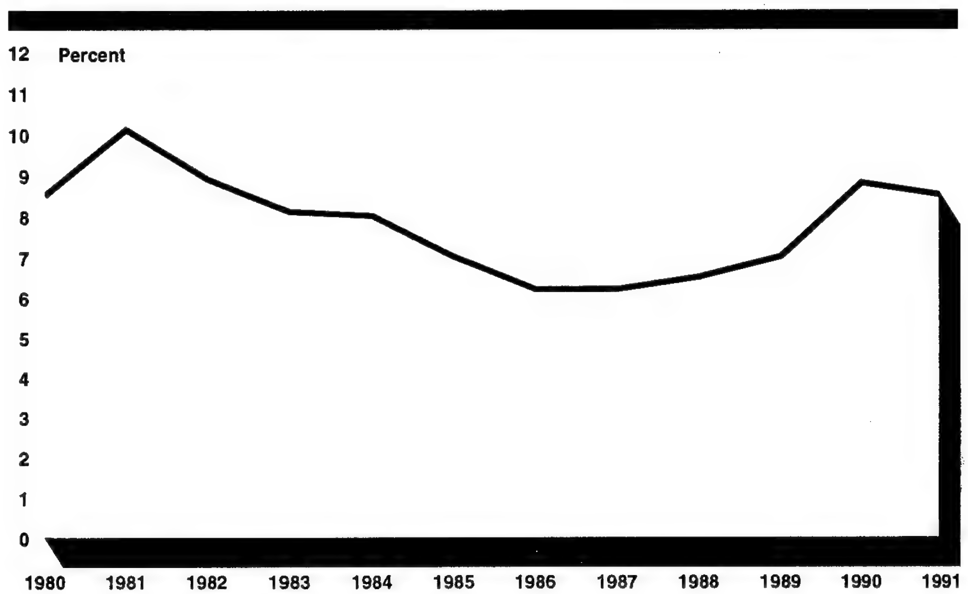
Source: OECD Economic Outlook, #55.

Figure III.5: General Government Net Debt Interest Payments in Germany, 1978-1992



Source: OECD Economic Outlook, #55.

Figure III.6: Long-Term Interest Rates in Germany, 1980-1991



Source: OECD Economic Outlook, #55.

Change of Government: Deficit Reduction as a Political Mandate

A coalition government of the Christian Democrats and the Free Democrats under Chancellor Helmut Kohl assumed power in October 1982, but it had to win approval from the public in the March 1983 general election. The campaign leading up to the general election provided a critical impetus for deficit reduction. Chancellor Kohl had pledged to do more to reduce the deficit than the Social Democrats, and he had to demonstrate that fact in time for the election. Upon assuming power, his government passed a supplementary act to accompany the 1983 budget which expanded the previous government's deficit reduction proposals. Kohl's coalition won a majority in the Bundestag in the election.

The German Balanced Budget Requirement

The German Constitution's balanced budget requirement did not preclude budget deficits. Article 110 of the Basic Law states that "the budget must be balanced as regards revenue and expenditure." However, article 115 defines a balanced budget as one where expenditures do not exceed the sum of revenues plus net borrowing for investment purposes.

Additionally, the Constitution allows exceptions to the balanced budget requirement. These are defined in the 1967 Law to Promote Economic

Stability and Growth. The law gave German governments greater discretion for running deficits. The law requires the federal and state governments to orient their budgeting towards the economic objectives of price stability, high employment, balanced foreign trade, and steady economic growth. According to a Ministry of Finance official, the Basic Law and the Law to Promote Economic Stability and Growth contain criteria which justified high deficits during the recessions of the 1970s as the government tried to reduce unemployment through deficit spending.

Germany's Constitutional Court also affects federal budgetary decision-making. The court has ruled on the constitutionality of tax laws and income redistribution and on whether the federal government was in compliance with the balanced budget requirement. In 1982, the Christian Democrats, then in the opposition, brought suit against the Social Democratic government for exceeding the constitutional limit on borrowing. In its 1988 ruling, the court decided that the need to stabilize the economy warranted borrowing in excess of investment. In a case decided in 1991, the court reinstituted a tax on investment income abolished by the federal government the year before. The court judged that it was unfair to exempt one form of income from taxes. In 1993, the court ruled that two state governments in budgetary difficulties were entitled to federal assistance to help balance their budgets.

Deficit Reduction Actions

The German government took steps in the first half of the 1980s to restrain public expenditure and boost revenues. These actions, combined with economic growth in the late 1980s that boosted tax revenues and the social security surplus, eliminated the German general government deficit by 1989.

Coordination and cooperation among levels of government helped bring down the deficit as each level of government took actions to ensure that total expenditure grew by no more than 3 percent annually in nominal terms. The Bundesbank estimated that the legislative packages enacted in 1982, 1983, and 1984 by the federal government resulted in a reduction in the general government deficit by DM55 billion or just over 3 percent of GNP in 1984. Other sources estimate the savings to be higher.

In the second half of the 1980s, the government did not pursue deficit reduction and expenditure restraint as consistently as it did between 1982 and 1984. Expenditure growth at the state and local levels of government generally exceeded the 3 percent goal between 1985 and 1989. However,

the federal government kept its expenditure growth below 3 percent per year until 1989 as increased individual contribution rates to social insurance and the reviving economy reduced the pressure on social security in the federal budget. The federal government also reduced income tax rates three times between 1986 and 1990.

Despite tax cuts, overall revenues continued to rise at an average nominal rate of nearly 4 percent from 1985 to 1988 as the economy expanded. In 1989, the year the general government budget showed a slight surplus, tax revenues jumped by 9.3 percent over the prior year as a result of the booming economy and because the German tax system was not indexed for inflation.

Spending Actions

Building on the deficit reduction proposals inherited in October 1982, the Christian Democratic-led coalition government under Chancellor Kohl made a concerted, sustained, and generally successful effort to constrain overall expenditure during its first 3 years in office. After 1985, new expenditure reduction initiatives were few and relatively modest. Overall, however, spending constraints in the years 1983 through 1985 had longer-term effects: public expenditure as a percentage of GDP fell to a low of 44.8 percent of GDP in 1989, down from 49.0 percent in 1982.

Table III.2 shows some of the estimated savings from expenditure actions taken by the Schmidt and Kohl governments between 1981 and 1985, and brief descriptions of the actions follow the table.

Table III.2: Estimated Impact of Selected Federal Expenditure Actions Leading to Public Sector Budget Savings in Germany

Deutsche marks in millions

Type of savings	1981	1982	1983	1984	1985	Total
Public investment reductions	3,120	5,070	3,850	1,020	0	**13,060**
Limits on unemployment benefits	0	3,500	4,000	4,000	4,000	**15,500**
Public employee wage and/or hiring freezes	0	2,300	2,500	2,700	2,900	**10,400**
Child benefits reduction	0	1,700	1,800	1,800	1,800	**7,100**
Subsidy reductions	0	3,400	1,800	1,500	1,400	**8,100**
Other expenditure savings	9,000	700	1,000	400	500	**11,600**
Annual total expenditure reductions	12,120	16,670	14,950	11,420	10,600	**65,760**
Savings as percent of total public sector outlays	1.6	2.1	1.9	1.4	1.2	1.6

Sources: Ministry of Economics, Council of Economic Experts, and OECD.

- Public investment. The most substantial reductions in expenditures made in the 1980s occurred in public investment. Total public investment was the only budget category cut in nominal terms each year between 1981 and 1984. According to a government official, the federal government eliminated a multiyear investment program in 1982, but the great majority of the investment reductions occurred at the local government level. All levels of government realized over DM13 billion in estimated budget savings between 1981 and 1984. The Bundesbank noted that this area is the easiest way for any German government to make immediate budget cuts for two important reasons. First, public investment in Germany is discretionary in nature and not subject to statutory commitments (unlike other current expenditures) and therefore can be cut back "drastically" in times of fiscal difficulties. Second, local authorities make about 70 percent of total public investments, and they can be compelled to reduce investment spending under public budget law.
- Unemployment benefits. The federal government restrained the growth in the unemployment and short-term work benefits administered by the

Federal Institute for Employment. Between 1982 and 1985, the Council of Economic Experts estimates that the government saved DM15.5 billion in this area. Approximately DM2.5 billion of these savings resulted from cutting benefits for unemployed recipients without children from 68 percent of their net wage to 63 percent in the 1984 budget.

- Public employment costs. According to a German economist, the Schmidt government froze civil service wages in 1981 and 1982, and the Kohl government limited pay increases to no more than 2 percent in 1983 and delayed the scheduled 1984 pay raise by 1 year. The government sharply curtailed civil service recruitment in the 1980s, choosing instead to hire lower paid part-time employees as needed. Altogether, public payroll savings worth DM10.4 billion were realized between 1981 and 1985.
- Child benefits. Universal child benefits paid to families for each child became means tested in 1982. Starting in 1983, the Kohl government eliminated tax relief for child care expenses and further reduced child benefits. The combined budgetary savings of these actions amounted to an estimated DM7.1 billion between 1982 and 1985. However, in 1986, Chancellor Kohl introduced a child-raising allowance of DM600 per month for the first 6 months with additional means-tested payments available up to 12 months and raised the tax allowance for each child. These actions went into effect in 1986.
- Subsidies. The government saved over DM8 billion between 1982 and 1985 by reducing subsidies. According to officials, the government reduced subsidies for hard coal, the aerospace industry, public housing, and farmers. However, increasing subsidies for shipping, agriculture, and miner's income support offset these savings in the 1980s.
- Other expenditure savings. The Schmidt government reported that it made DM9 billion worth of unspecified savings in the 1981 budget. Between 1982 and 1985, the Kohl government saved over DM2 billion by reducing or postponing military and civilian pension benefits. The government also converted university student grants to no-interest but time-limited loans, and cut subsidies for student housing rents.

Revenue Actions

The government under Chancellor Kohl continued revenue actions initiated by the previous government as well as initiated its own. However, a number of economists and government officials told us that deficit reduction was not achieved by increased revenues. They said revenue increases were generally offset by measures taken to meet other policy objectives such as the income tax rate reductions in the second half of the 1980s. Revenues for all levels of government declined from 45.7 percent of GDP in 1982 to 44.9 percent in 1989.

Although many of the revenue increases were offset by spending in other areas, the Bundesbank estimates that the following actions helped reduce public sector deficits during the 1980s.

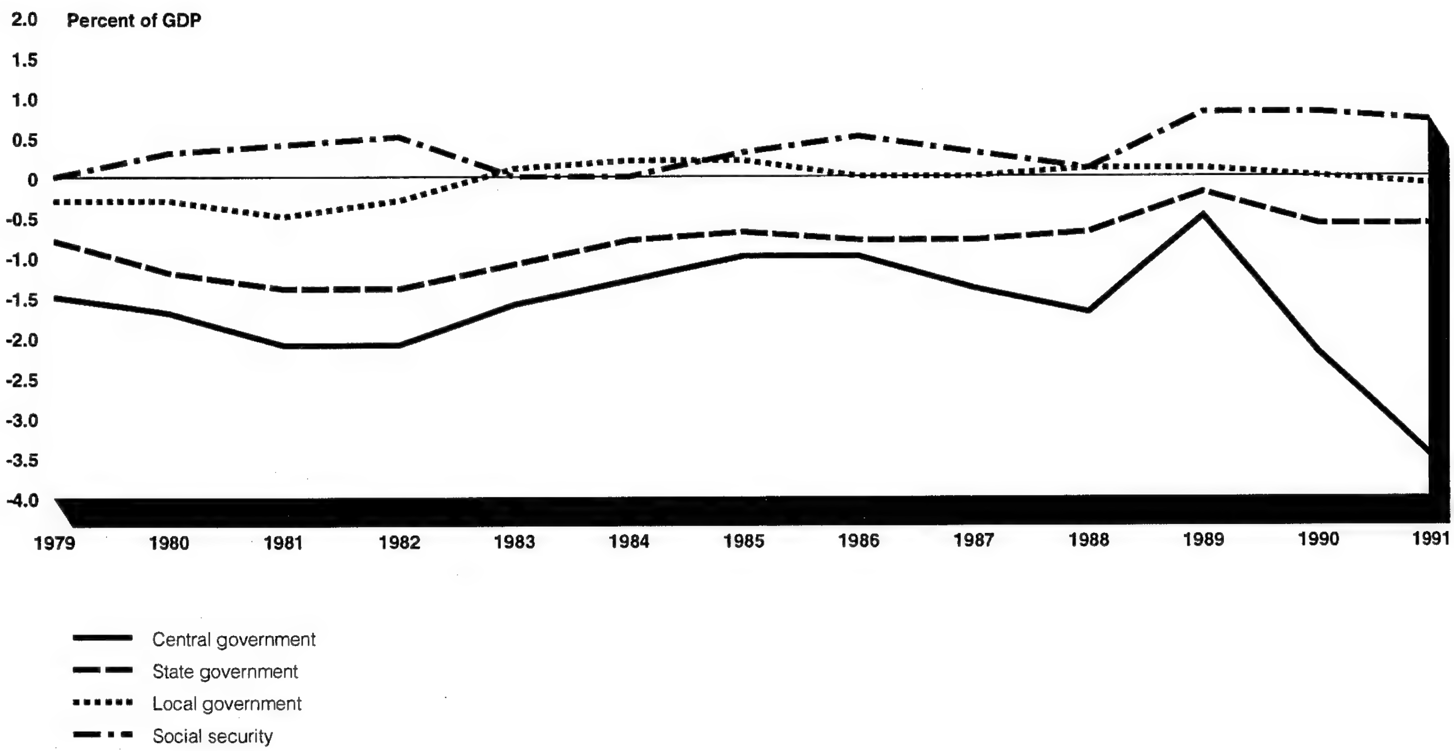
- Federal consumption taxes. The Schmidt government raised taxes on fuel oils, gasoline, and alcohol by DM2.5 billion in 1981. It also increased taxes on tobacco, spirits, and sparkling wine, raising DM11.5 billion between 1982 and 1985. The government's "coal-penny" tax raised DM21 billion between 1981 and 1987, but it was used to offset the cost of mining subsidies. In 1989, the Kohl government increased excise taxes on petroleum products, tobacco, insurance, and diesel-engine automobiles, and imposed a new tax on natural gas, to raise an estimated DM8.5 billion.
- Value added tax (VAT). Kohl's government increased revenues between 1982 and 1990 by raising the value added tax rate from 13 percent on most goods and 6.5 percent on special goods to 14 percent and 7 percent, respectively. This raised about DM3 billion in additional revenues in 1983; rising to DM10 to 15 billion each year thereafter, according to one estimate.
- Tax expenditures. The Kohl government raised about DM21.2 billion between 1982 and 1990 by reducing tax allowances and loopholes. In 1990, the government reduced or abolished 62 tax allowances, for a net savings of DM18 billion.
- Investment income tax. As a result of a Constitutional Court ruling, the Kohl government imposed a 10 percent investment income tax in 1989 that raised an estimated DM8 billion its first year, but banking officials and some economists noted that widespread tax evasion limited the value of this measure.
- Privatization. The government's efforts to privatize some of its assets had relatively little impact on reducing the deficit in the 1980s. The government raised about DM10 billion through privatization, largely through sales of government shares in private companies.

Economic Growth and Increased Social Security Contributions

Strong economic growth in the latter part of the 1980s contributed to elimination of the general government deficit by 1989. The social security budget surpluses increased as the government increased the contribution rates, while improving economic conditions reduced unemployment from 7.1 percent in 1985 to 4.8 percent in 1990. In 1989, the unusually large social security surplus offset the lowest combined federal, state and local government budget deficit of the decade, resulting in an overall budget surplus. Figure III.7 shows the OECD deficit measure referred to as "net

lending" for federal, state and local, and social security funds during the 1980s.

Figure III.7: Net Lending in Germany, 1979-1991



Source: OECD National Accounts, Volume II.

Concurrent with strong economic growth, tax revenues increased significantly in 1989. According to some officials, the three income tax rate reductions made between 1986 and 1990 were necessary to compensate for the "fiscal drag" that occurred when rises in incomes due to inflation placed people in higher tax brackets. Although the first two income tax rate reductions—in 1986 and 1988—reduced net revenues by DM25 billion, OECD reported that overall direct tax revenues still grew by over DM27 billion, or 10.8 percent, between 1988 and 1989. Indirect tax

revenues increased by just over DM21 billion in 1989, or 8.3 percent, almost double the growth rate of indirect tax revenues in 1988.

Reaching Agreement

According to a German official, the Social Democratic leaders were unable to generate the needed support for deficit reduction within their own party and from their coalition partners in the early 1980s. The opposition Christian Democrats and the media criticized the government's deficit reduction efforts as insufficient. In October 1982, the Free Democrats switched sides and joined the Christian Democrats and the Christian Social Union in a vote of no confidence that brought down the government.

The Kohl government gave immediate priority to deficit reduction, then later followed with tax rate reductions. The government's goal over the medium term was higher economic growth with a smaller government. The government focused on reducing expenditures to ease pressure on the credit markets and to make the terms for private investment more favorable.

The government's strategy included securing the cooperation of the various levels of government and the Bundesbank, which independently controls monetary policy. Chancellor Kohl capitalized on the sense of economic crisis to secure the cooperation of state and local governments to voluntarily keep expenditure growth within the 3 percent growth target recommended by the Council of Economic Experts. Government economic experts agreed that as a result of spreading public concern about high interest rates, "crowding out" effects, and the general fear about financial instability, the new government had little difficulty in convincing the state and local authorities to reduce their deficits.

Chancellor Kohl's government introduced the majority of the deficit reduction efforts for Bundestag approval between late 1982 and 1984. The task of the new government in obtaining consensus for its deficit reduction policies was assisted by a pre-existing belief shared by many policy makers, economists, journalists, and much of the general public that the lost budget flexibility required a new economic strategy which included budget deficit reduction.

Securing the cooperation of the Bundesbank was important for the success of this budget strategy. Expenditure and tax reduction policies brought fiscal policy into line with the anti-inflationary monetary policy

the Bundesbank pursued in the 1970s and throughout the 1980s. According to Bundesbank officials, convergence of the two policies had favorable effects on the economy. The reduction of public expenditure as a percentage of GDP helped to ease inflation and encouraged the bank to bring down the high interest rates it had maintained to control the inflationary pressures of the late 1970s. As interest rates came down, growth in debt interest costs also declined from a high of 22.8 percent in 1982 to 4 percent in 1988.

Officials we interviewed disagreed on the extent to which Chancellor Kohl was involved in securing the cooperation of the powerful national trade unions. One economist said the government used the economic crisis to secure restrained wage demands from the public unions and then used the results to influence the wage demands of private sector unions. Other observers stated that the pressures of the recession were much more influential in restraining union wage increase demands than the government's policies.

Cost Shifting Was Not a Major Deficit Reduction Strategy

Shifting of responsibilities and program costs among levels of government as a deficit reduction strategy did not seem to occur in Germany to the degree that it did in some of the other case study countries such as Australia and Canada. According to one economist, cost shifting from the federal to other levels of government was not a major factor during the 1980s because tax revenues shared by the state and federal government were high. Local officials argued, however, that the federal deficit was reduced, at least in part, at the expense of local government.

Federal officials told us that the states have benefited more from increases in the VAT than the federal government: in 1980, the federation received 67.5 percent of VAT revenues, and the states received 32.5 percent; in 1990, the ratio was 65 percent to 35 percent. One official also stated that the proportion of total income tax revenues allotted to the local governments rose from 14 percent to 15 percent in the 1980s. Furthermore, according to a government official, the federal government pays the entire German contribution to the European Union out of its portion of VAT funds, leaving it only about 50 percent of the total VAT revenue for its own use.

One local government official stated that because local governments control approximately two-thirds of all investment-type expenditures, they had to sacrifice when the federal government reduced investment spending. He also said local governments had trouble paying operations

and maintenance costs on earlier investment projects when federal investment was reduced.

Budget Deficit Reduction Was Also Assisted by Factors Outside Government Control

One leading economic institute official said the government's budget deficit reduction efforts were assisted by the fortuitous timing of external factors during the 1980s. These factors included (1) increased exports to the United States, which contributed to the reversal of the current account deficit to a surplus by the end of the decade, and (2) the U.S. stock market crash of October 1987, which spurred the Bundesbank to lower interest rates beyond what it might otherwise have done.

In addition, the Bundesbank's annual profits had a measurable impact on the deficit because they are turned over to the government to augment current revenues. The bank's profits grew from DM2.3 billion in 1981 to DM12.7 billion in 1986, dropped to DM200 million in 1988, and then increased to DM10 billion in 1989 and 1990. Since 1990, a maximum of DM7 billion can be included in the annual budget, and the rest must be used to reduce the overall debt.

Budget Deficits During the 1990s

The general government budget balance went from a surplus of 0.1 percent of GDP in 1989 to a deficit of 3.3 percent of GDP in 1993. In addition, gross public debt increased from 43.2 percent of GDP to 48.5 percent of GDP. The increase in budget deficits and debt was the result of the unification of Germany in 1990 and the worldwide recession which overtook Germany in 1992. It was also a result of a breakdown in consensus over expenditure restraint at the three levels of government.

Current Deficit Reduction Strategy

Revenue increases have played a large part in the government's deficit reduction strategy during the early 1990s. As the deficit began to grow rapidly through large expenditure increases, the government took steps to control the growing deficit by raising revenues in 1991. The federal government imposed a 1-year 7.5 percent "Solidarity" income tax surcharge in July 1991, and increased tobacco, mineral oil, and insurance taxes. It raised the social security contribution as well, raising pension contributions by 1.7 percentage points in 1993 to reduce the shortfall between actual contributions and the statutory minimum fund level. The government also cut expenditures, mainly by cutting defense and reducing some funding for communities along the old inner-German border.

After 3 years of reduced cooperation on deficit reduction, the three levels of government adopted the Solidarity Pact in May 1993. The governments agreed to increase levies, retool government, and consolidate the budget. This pact targeted social benefits and personnel costs. These measures were expected to reduce the federal budget deficit by cutting expenditure, increasing revenue through minor tax changes, and cancelling a planned reduction in the unemployment fund contribution rate. The federal government secured this pact, according to one OECD economist, by agreeing to turn more of its VAT funding over to the states.

While states have agreed to again constrain expenditures, according to a government official, a 1993 Constitutional Court decision may give states less incentive to control deficits in the future. The court ruled that the two West German states of Bremen and Saarland have a right to get help from the federal government to overcome their financial problems. Thus, some observers believe this Constitutional Court decision guarantees payment by the federal government of state and local debt.

Government officials pointed out that Germany faces serious demographic problems. The population is getting older, and there are fewer working age people to support the pension insurance system. Nonwage benefits continue to keep the cost of hiring additional employees high for employers. Rising public health care expenditures are also of concern to the government. A number of economists and government officials believe that further budget deficit reduction should come through expenditure reduction because they believe that the economy has reached the upper limit of what it can bear in taxation.

Conclusion

The federal government capitalized on the sensitivity of the public to the economic turmoil in Germany's past and on its political majorities at the state and federal level to mobilize consensus for deficit reduction, and to secure the cooperation of the other levels of government. The federal, state, and local governments agreed to contain the growth in expenditures to no more than 3 percent per year over the medium-term future. Although tax reform included income tax rate reductions, the lack of indexation of income taxes, increases in other taxes, and economic growth contributed to strong government revenues.

Japan

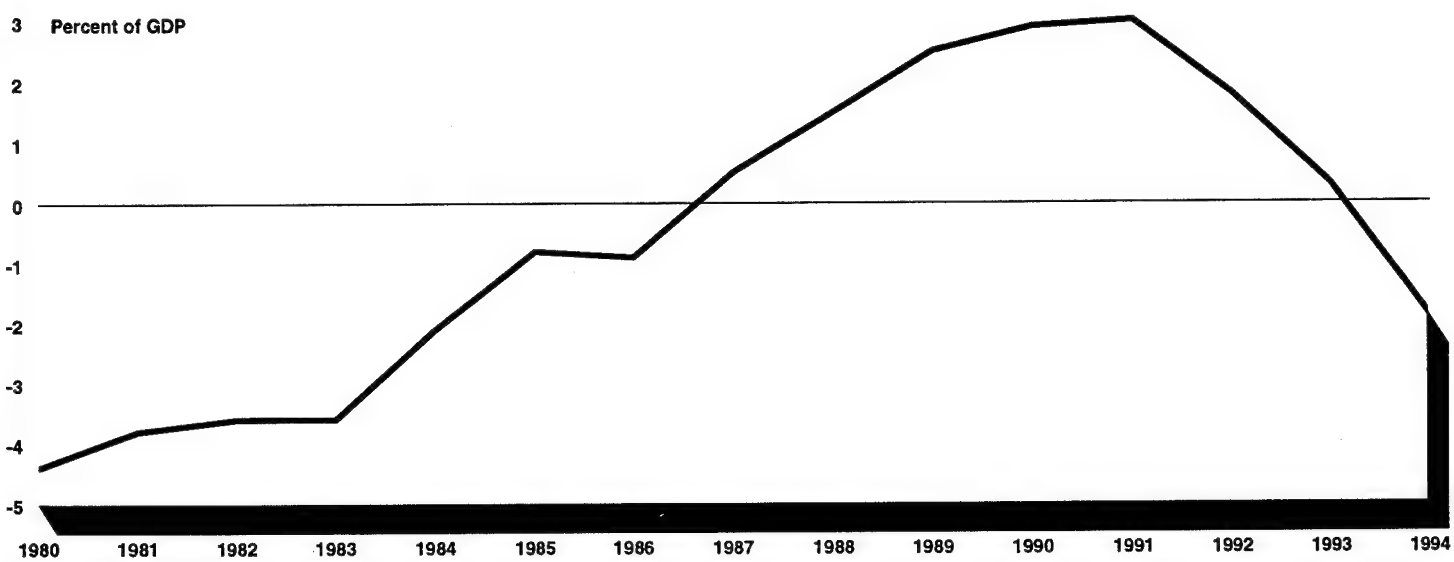
Japan experienced general government[1] budget deficits between 1975 and 1986, which peaked at 5.5 percent of gross domestic product (GDP) in 1978. The fiscal deficits were a result of the oil price-induced recession of 1973 in combination with a general worldwide decline in economic growth rates. These factors influenced the economy of Japan at the same time that (1) social welfare spending commitments increased and (2) the country was asked by the other industrialized nations to undertake stimulus spending in an attempt to boost the world economy.

The Japanese government took action to reduce the deficit because of concerns about the long-term implications of growing levels of debt and the rising share of the budget allocated to interest costs. These problems, rather than an economic crisis, such as a loss of access to credit markets, appeared to have prompted the government to undertake fiscal measures to reduce the deficit.

Japan was able to accomplish significant deficit reduction primarily by taking advantage of strong economic growth during the late 1980s, which dramatically increased tax revenues, and by imposing long-term expenditure ceilings on certain discretionary components of the budget that remained in place during times of both growth and recession. Since Japan's tax system is not indexed for inflation, inflation-induced bracket creep also contributed to the rising level of government revenues. The ratio of income taxes to the national income rose from approximately 3.6 percent in fiscal year 1965 to 7.3 percent in fiscal year 1990, as a result of automatic increases caused by economic growth and inflation. Strong revenue growth combined with expenditure ceilings that permitted either zero nominal growth or actual declines in certain classes of expenditures enabled the Japanese government to convert its deficits to surpluses by 1987. Japan is projected to have returned to deficit in 1994. Figure IV.1 illustrates Japan's general government deficits and surpluses, while figure IV.2 provides data on receipts and outlays.

[1]The Organization for Economic Cooperation and Development defines general government as all levels of government combined, including social security trust funds.

Figure IV.1: General Government Financial Balance in Japan, 1980-1994



Note: Data for 1994 are based on OECD projections.

Source: OECD Economic Outlook, #55.

Figure IV.2: General Government Revenues and Expenditures in Japan, 1980-1994

Note: Data for 1994 are based on OECD projections.

Source: OECD Economic Outlook, #55.

Background

It is difficult to appreciate the deficit reduction actions and strategies taken by the Japanese government without understanding the political and budgetary context in which they took place. The budget process and structure, and the relationship between the budget and political process, are especially complex in Japan. This background section, therefore, provides detailed information on the budget process and structure and on the political system in Japan in an attempt to provide a meaningful context for the deficit reduction actions and strategies of the Japanese government.

The constitution in Japan is based on a system of parliamentary democracy. The Japanese parliament, the Diet, is composed of two chambers, the House of Representatives (known as the lower house) and the House of Councillors (known as the upper house), both of which are

directly elected by the public. The Prime Minister is normally the president of the majority party in the House of Representatives and is elected by the Diet. Both Diet chambers have similar duties, but the House of Representatives has the final word if differences exist between the two chambers and has the power to force the government to resign.

From 1955 to 1993, a conservative party, the Liberal Democratic Party (LDP) consistently held the majority and, accordingly, controlled the government. During the 1980s, despite the stability of the LDP, six different individuals held the office of Prime Minister. The LDP lost to a reform-minded coalition government in 1993, but this government was subsequently replaced by a Socialist/LDP coalition government in 1994. The deficit reduction actions on which we focus in this report fall entirely within the period of the LDP majority.

Responsibilities of Different Levels of Government

The public sector in Japan is composed of the central government and the local governments, which consist of 47 prefectural and 3,200 municipal governments. Local governments are responsible for the maintenance and management of facilities for health, welfare, and education, and for water supply, sewage, and sanitation services, as well as for ensuring the safety and welfare of residents.

Japan is a unitary system—the principal powers are held by the central government. The central government controls most local government activities through guidelines, standards, and regulations, and all local borrowing is controlled at the central level. However, the central government does delegate functions to the local governments; as of 1993, more than half of the functions performed by prefectural governments were delegated from above.

Private enterprises in Japan supplement the role of government, which helps to reduce the government's social welfare burden. Employers often provide extensive social benefits; for example, lifetime employment is still provided by some large corporations. Unemployment rates are low in Japan by international standards; in 1993, the unemployment rate was 2.5 percent.

Budget Process

In Japan, ministries and other agencies begin to prepare individual budgets for the following year shortly after the beginning of the fiscal year on April 1. The Constitution states that the annual budget is to be prepared by

the Cabinet, but the Public Finance Law of 1947 assigns the responsibility of actual preparation to the Ministry of Finance (MOF). MOF controls the main components of the budget process—for example, it formulates the budget guidelines and expenditure ceilings, which are then finalized by the Cabinet. Experts have stated that the allocation of resources in the budget is, therefore, primarily based on administratively predetermined levels of funding.

Traditionally, the Diet does not amend the budget once it has been submitted for approval by MOF. This does not mean, however, that Diet members have no influence on budgetary decision-making. Extensive discussion takes place behind the scenes throughout the budget cycle involving MOF, politicians, private interest groups, and the ministries. Traditionally, senior Diet members have formed "Zoku," which translates as "tribes" or "clans," to lobby MOF on behalf of the spending ministries within their domain. While former Prime Minster Morihiro Hosokawa has been quoted as describing the policy-making process in Japan as collusive, analysts have stated that the basic goal of the budget process in Japan is to reach consensus. Consultations conducted by MOF during budget formulation serve to establish a consensus before the budget is presented to the Diet, and the Diet does not normally change the budget once it has been submitted by MOF.

Observers have noted the importance of consensus in Japanese society, and consensus is central to its budgetary and political decision-making. In practice, the Diet determines not only procedural matters but also policy matters by consensus. This can sometimes make it difficult for the government to pass controversial initiatives. For example, the government's attempt to introduce a form of consumption tax in 1979, called a value added tax (VAT), foundered because the tax was unpopular both with the public and with various factions within the Diet. The lower house of the Diet was forced to dissolve in 1980, primarily because of the inability of its members to reach consensus on the fate of the VAT. The VAT ultimately passed the Diet in 1989.

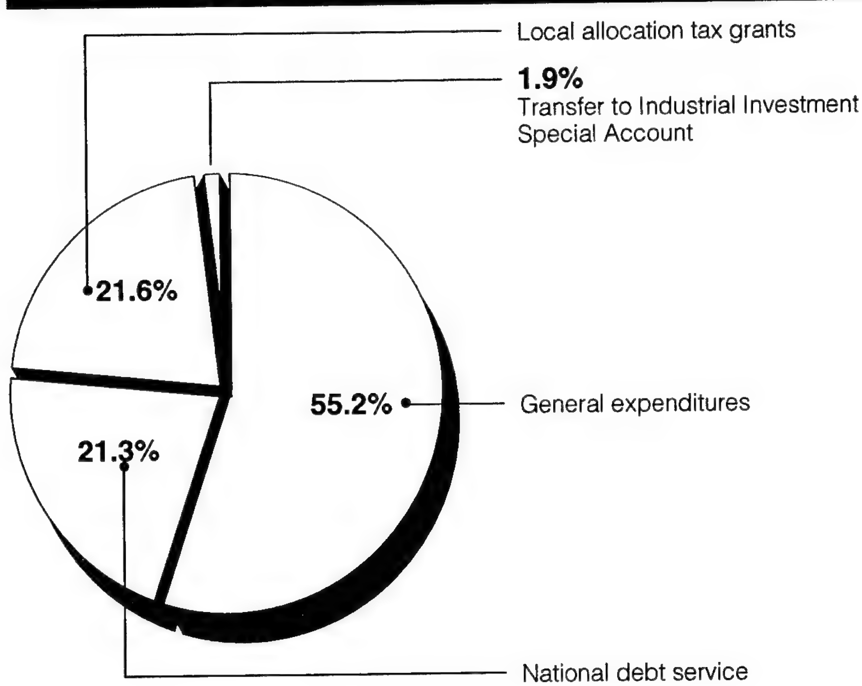
Budget Structure

The definitions of budgetary balance used by Japan to develop its fiscal and budgetary policies differ significantly from those used by the Organization for Economic Cooperation and Development (OECD). In Japan, the term budget normally refers only to the general account of the central government. In contrast, OECD normally uses general government data in its country analyses and determines deficit and surplus based on

all accounts at all levels of government and social security funds. The government of Japan, however, does not consider social security or local government budgets as part of the general account budget.

The general account budget is composed of general expenditures, national debt service, local allocation tax grants, and transfers to the industrial investment special account. Figure IV.3 illustrates the components of the general account budget. The expenditure side of the general account consists of 13 major programs, including social security, education and science, national defense, public works, and economic cooperation. The general account is financed primarily by direct and indirect tax revenues and proceeds from public bonds. In fiscal year 1993, it totaled approximately 72.4 trillion yen.

Figure IV.3: General Account Budget Components in Japan



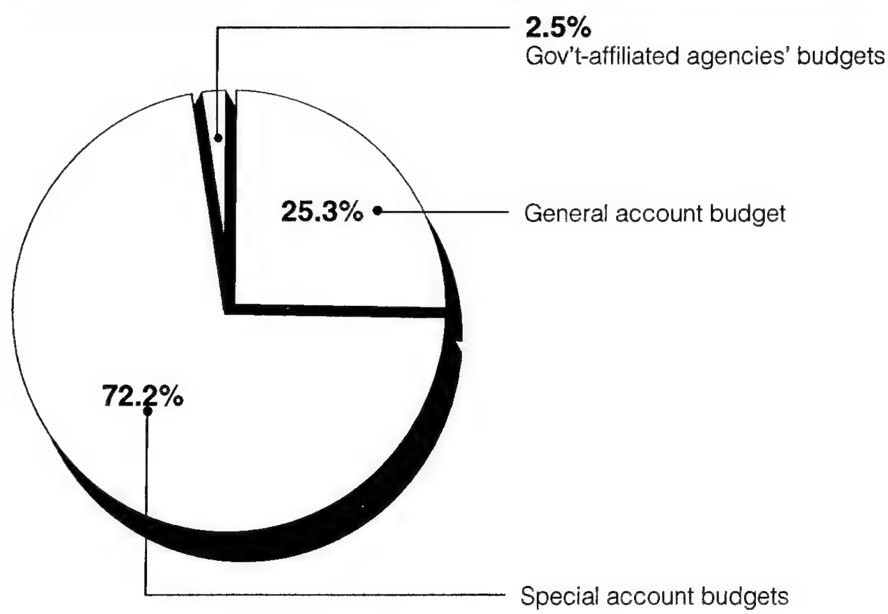
Note: Based on the 1993 initial budget.

Source: The Japanese Budget in Brief, 1993.

The central government budget consisted of 38 special account budgets in 1993 in addition to the general account. Some special accounts are established for specific projects, such as highway and airport construction; others are created to fund specific purposes with specific revenues. Some of these accounts have their own source of revenues, and some may use revenues obtained from borrowing. In fiscal year 1993, the special account budgets were approximately three times the size of the general account budget; however, there are significant cash flows between the general account and the special account budgets.

The budgets of the 11 government-affiliated agencies are also considered part of the central budget but not part of the general account budget. These are public corporations which are closely tied to government policies and whose budgets are subject to approval by the Diet. In fiscal year 1993, the total of their budgets was 7.2 trillion yen. Figure IV.4 displays all of the components of the central government budget.

Figure IV.4: Central Budget Components in Japan



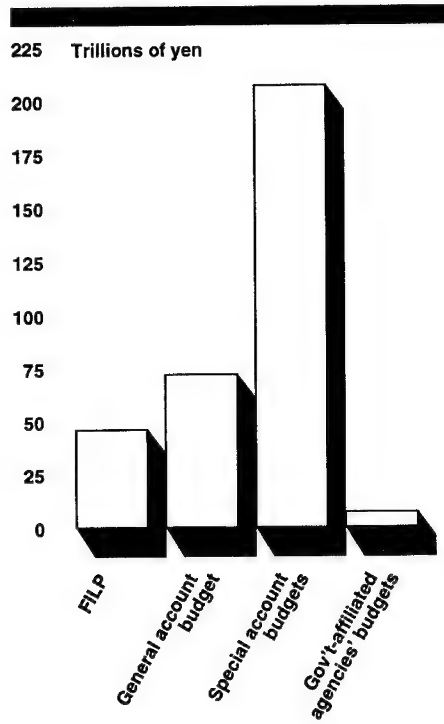
Note: Based on 1993 initial budget.

Source: The Japanese Budget in Brief, 1993.

The Fiscal Investment and Loan Program (FILP)

Another important funding source in Japan is an investment program called the Fiscal Investment and Loan Program (FILP). FILP is 60 percent the size of the general account budget, at 45.8 trillion yen, and is often referred to as Japan's second budget. Figure IV.5 displays the sources of government funding. The FILP budget is submitted to the Diet for approval at the same time as the general account budget, but FILP funds are administered solely by the Ministry of Finance. Compared with the general account budget, the government has greater discretion to use FILP without requesting approval from the Diet. FILP lending is not reflected in the general government balance; according to OECD calculations, if FILP were included in Japan's debt figures, gross debt would rise by approximately 1 percent of GDP.

Figure IV.5: Government Funding Sources in Japan



Note: Based on the 1993 initial budget.

Source: The Japanese Budget in Brief, 1993.

Funding sources for FILP include public funds that are collected through the postal savings system, which is comprised of personal savings deposits and government annuity and pension plans. FILP invests, finances, or guarantees debt to government-affiliated financial institutions, such as the Government Housing Loan Corporation, the Export-Import Bank of Japan, and the Metropolitan Expressway Public Corporation, which then invest primarily in projects that generate profits.

An MOF analyst stated to us that the goal of FILP is to finance and promote public policies that the private sector will not finance due to low rates of return. FILP funds are used specifically to (1) promote policy priorities, such as housing, social welfare, and environmental protection, and (2) promote public works that have a positive rate of return, such as airports, railway lines, and toll roads.

While many of the other case study countries significantly reduced capital investment expenditures during the 1980s, in Japan, overall government investment—including FILP—did not decline. According to OECD, while investment as a share of central government expenditures declined, the ratio of general government investment to gross national product did not decrease due to increased investment expenditures by FILP, interest-free loans using the proceeds from privatization (described in the following section), and increased investment expenditures by the local governments.

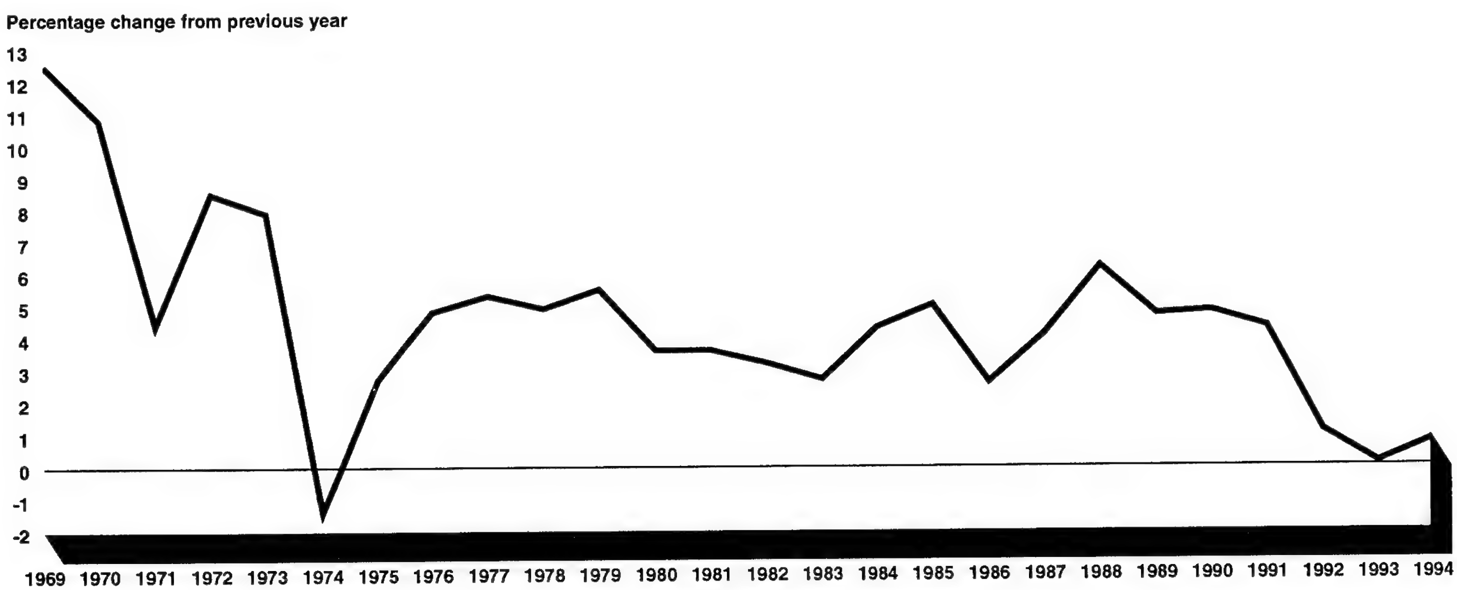
Causes of Deficits During the 1970s and 1980s

Japan experienced significant general government deficits between 1975 and 1986. The deficit reached its peak in 1978, at 5.5 percent of GDP and slowly began to decrease after that point. A number of factors contributed to the growth of deficits in Japan, including a long-term decline in the economic growth rate, oil-price shocks and recession, and an increase in social welfare spending. Following World War II, Japan underwent a period of extremely high growth as it recovered from the devastation of its economy during World War II. Productivity increased at a rapid pace during that period, but by 1970, these productivity gains began to slow, and the oil price-induced recessions of 1974 and 1979 deepened the effects of slowing economic growth. Prior financial commitments to expand social welfare programs and stimulative spending undertaken at the request of other industrialized nations required Japan to issue deficit financing bonds in 1975 to cover a growing budgetary gap.

Slowdown in Economic Growth and Oil Price Shocks

The rate of economic growth in Japan was extremely high during the 1960s; between 1960 and 1973, average annual real economic growth was 10.9 percent. By the mid-1970s, however, the growth rate of the economy began to slow both in Japan and in other advanced countries; between 1974 and 1980, the average annual growth rate had dropped to 3.6 percent. Figure IV.6 illustrates the growth rate in the economy between 1969 and 1994.

Figure IV.6: Real GDP Growth in Japan, 1969-1994



Note: Data for 1969 through 1977 are presented as a percent of GNP. Data for 1994 are based on OECD projections.

Source: OECD Economic Outlook, #46 and #45.

The disruption of oil supplies in 1973 led to a recession in 1974 and a long-term slowdown in economic growth, which resulted in significantly reduced tax revenues.

Expanding Social Responsibilities

In the 1970s, the Japanese government made extensive additions to its social security system.[2] For example, it introduced free medical care for the elderly and subsidies for expensive medical treatments. The Japanese government also introduced the children's allowance during this period, which is a nationwide system covering families with children who have not yet completed compulsory education. The government also raised the ratio of old-age public pensions from about 20 percent of the average salary to 43 percent. Social welfare benefits were indexed to inflation in the early 1970s; the rapid inflation that occurred in the following year caused a significant increase in benefit costs.

Health care costs are expected to increase in Japan in the next century due to the rapidly increasing proportion of the population that is over 70 years of age and the high concentration of health care spending devoted to the elderly. Improvements in medical technologies are also expected to contribute to increases in health care costs. Japan has a system of universal health care that is limited to basic services, which imposes price controls as well as limits on overall health spending to help control spending growth.[3] In Japan, public expenditures on health (as defined by OECD) increased by 0.2 percent of GDP between 1980 and 1991. In the United States, public expenditures on health rose by 2 percent of GDP during the same period.

Stimulus Spending

Stimulus spending in the late 1970s also contributed to the growth of the deficit. In 1977, the industrial countries formulated the "locomotive theory," the belief that the United States, Japan, and Germany could and should simultaneously stimulate their economies in order to increase world growth. Japan agreed to implement policies that would increase real gross national product and deliberately increased spending in excess of revenues.

Defining Balance

Budgetary balance, according to the Japanese government, refers to the balance of the central government general account budget. The Public Finance Law of 1947, the basic budget law in Japan, states that the Japanese government can issue bonds only if the funds are to be used for

[2]The social security system in Japan is made up of public assistance, social welfare, social insurance (medical-care insurance, public pensions, unemployment insurance, and workers' accident compensation insurance), public health services, and measures for the unemployed.

[3]Health Care Spending Control: The Experience of France, Germany, and Japan (GAO/HRD-92-9, November 15, 1991).

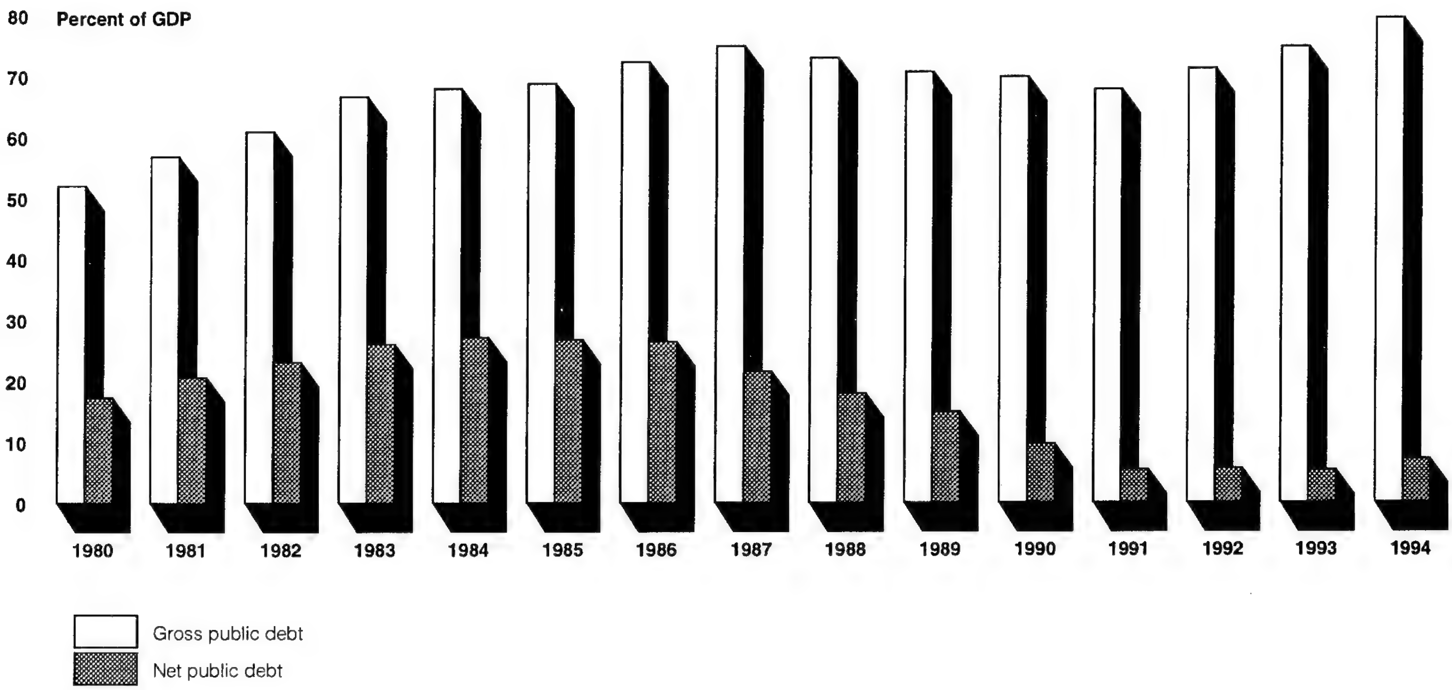
public works, investment, and governmental loans. The Japanese culture places a high priority on savings, and prior to 1965, the Japanese government chose not to issue construction bonds. In 1965, the government issued construction bonds for the first time, in response to a slowdown in economic growth, and has issued them ever since.

In 1975, Japan's expenditures exceeded its revenues. In exception to the Public Finance Law, the Japanese government began issuing special deficit financing bonds to close the general account budget gap and to finance current expenditures. The Diet was required to pass a special resolution in order to permit the issuance of the deficit financing bonds. In 1980, the government announced that its goal was to reduce the accumulation of outstanding government bonds by terminating the issuance of all new deficit financing bonds by 1984. The government ultimately succeeded in reaching this goal in 1990.

Despite the different labels, construction bonds and deficit financing bonds are essentially the same. A fairly clear delineation between capital and current spending, however, has permitted the government to place separate spending ceilings, as described below, on each type of expenditure. Officials told us, however, that the government has been broadening its definition of capital, which has resulted in a rapid increase in the types of things that can be financed with construction bonds.

The accumulating deficits resulted in an increase of gross debt from approximately 12 percent of GDP in 1970 to 52 percent in 1980. The Japanese government was able to reduce gross debt between 1987 and 1991, but the debt began to rise again in 1992, reaching close to 75 percent of GDP in 1993. Net debt in Japan, which is calculated by netting out the large assets held by the social security fund, is significantly lower than in most other industrialized nations; in 1993, it was 5.3 percent of GDP, compared to 39.3 percent in the United States and 33 percent for the OECD average. MOF has stressed that gross debt provides a more accurate representation of the budgetary situation in Japan than net debt since gross debt reflects all of the government's liabilities, including future pension costs. Figure IV.7 illustrates the levels of both gross and net public debt in Japan.

Figure IV.7: General Government Gross and Net Debt in Japan, 1980-1994



Note: Data for 1993 and 1994 are based on OECD projections.

Source: OECD Economic Outlook, #55.

Impetus for Reducing the Deficit

Our discussions with Japanese officials suggest that a combination of factors led the Japanese government to end its reliance on deficit financing; however, the long-term concern over the aging of the population and the resulting growth in health and pension costs were essential components of this decision. Government officials told us that it was imperative to build reserves for future pension outlays. In addition, there was concern that the growing interest payments were limiting the government's ability to make budgetary choices. The government also emphasized to the public that increased taxation would be necessary if spending control measures were not promptly undertaken.

Interviewees said that the Japanese government was very concerned about future pension obligations and the rapid aging of the Japanese population. The social security system is in surplus in Japan because the ratio of

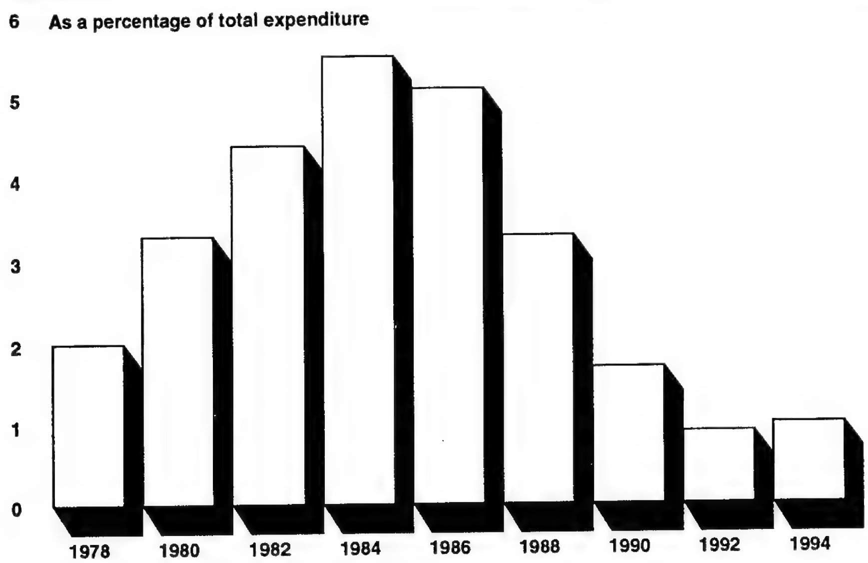
pension recipients to contributors is relatively low. The population is aging rapidly, however.

Approximately 12 percent of the population was over 65 in 1990, and this is expected to rise to 25.5 percent by 2020. This is a function of factors such as increased life expectancies and declining fertility rates. OECD has calculated that the present value of future net pension liabilities amounts to 200 percent of GDP in Japan compared to 43 percent in the United States.[4] Thus, although the social security system currently has annual cash surpluses, on an actuarial basis it would be in deficit.

Interest payments on outstanding bonds nearly doubled between 1980 and 1985, and by 1983 interest payments surpassed every expenditure except social security in the general account budget. Figure IV.8 illustrates the change in general government debt-related interest costs. Japanese economists said they believed that the debt and its associated interest costs were beginning to crowd out private investment, and government officials and business leaders reached the consensus that it was essential to control the deficit and the growing debt.

[4]OECD Economics Department Working Paper #142, Pension Liabilities in the 7 Major Economies, 1993.

Figure IV.8: General Government Net Debt Interest Payments in Japan, 1978-1994



Note: Data for 1994 are based on OECD projections.

Source: OECD Economic Outlook, #55.

Deficit Reduction Actions

Successful deficit reduction in Japan was heavily dependent on the strong economic growth that occurred in the late 1980s. Japan's tax system is not indexed, and real growth as well as inflation-induced bracket creep significantly increased Japan's revenues. Strict spending ceilings that MOF placed on some government expenditures within the general account budget also contributed to deficit reduction, although the significance of these expenditure reductions has been debated. Ceilings were set at rates below inflation, but budget experts stated that the budget reductions were to a large extent superficial. While expenditure growth was constrained, some costs were shifted to the local governments, and social security contributions were increased.

Tax reform did not play a significant role in deficit reduction. When the government attempted to implement a value added tax in 1979, it met with extreme opposition from Diet members, the public, and the business community. In 1980, the lower house of the Diet was forced to dissolve, largely due to its inability to come to a consensus on the issue of the VAT. The VAT was reintroduced in 1986 but did not pass the Diet until 1989, when it was promoted and implemented as a revenue-neutral tax. It was

introduced at 3 percent, which is low compared to VATs in other OECD nations. At the same time that the government introduced the VAT, it reduced the base corporate tax rate and lowered and simplified personal income tax rates. The new tax was intended to broaden the tax base as well as shift more of the weight of taxation from direct taxes, such as the income tax, to indirect taxes, such as the consumption tax. The government does not index tax rates, but it did provide annual tax cuts prior to 1974 to compensate for automatic tax rate increases.

The following is a more detailed description of some of the major contributors to deficit reduction during the 1980s.

- Economic growth. Strong economic growth and high asset prices during the late 1980s, referred to as the "bubble period," dramatically increased tax revenues and were essential in helping Japan reduce its dependance on deficit financing bonds. Japan experienced its second-longest boom since World War II, which lasted from 1987 to 1990.
- Expenditure ceilings. Since 1961, MOF has set budget guidelines for the budget requests for each ministry and agency within Japan. The guidelines, or ceilings,[5] are in nominal terms, apply to only a portion of the expenditures within the general account budget and use as their base the previous year's budget. In principal, the guidelines are applied equally to all expenditures, but each ministry determines its own expenditure priorities within the determined ceilings.

In the 1960s, the budgets were allowed to grow quickly, but at the end of the 1970s, MOF significantly increased the stringency of the budget requests. In 1961, for example, the budget request was permitted to increase up to 50 percent over the previous year's budget. This growth, however, was gradually reduced until spending was frozen in 1982. Table IV.1 provides detailed information on the annual levels of these ceilings on nominal budget growth. In 1984, the growth limit for those current expenditures under the ceilings was reduced 10 percent from the previous year's rate of increase, while the ceiling for applicable investment expenditures was reduced by 5 percent. Growth of the applicable current expenditures has been reduced by 10 percent from the previous year's growth each year up through 1993.

[5]In Japan, the term "ceiling" refers not to a nominal currency amount but to the limit on growth permitted from year to year.

Table IV.1: Guidelines for Budget Request Increases in Japan, 1961-1993

Fiscal year(s)	Nominal increase/decrease
1961-1964	Maximum 50 percent increase
1965-1967	Maximum 30 percent increase
1968-1975	Maximum 25 percent increase
1976	Maximum 15 percent increase
1977	General administrative expenses: Maximum 10 percent increase Other expenditures: Maximum 15 percent increase
1978-1979	General administrative expenses: Current office expenses-0 percent increase Other-maximum 5 percent increase Other expenditures: Maximum 13.5 percent increase
1980	General administrative expenses: 0 percent increase Other expenditures: Maximum 10 percent increase
1981	General administrative expenses: 0 percent increase Other expenditures: Maximum 7.5 percent increase
1982	0 percent increase
1983	Current expenditures: 5 percent decrease Investment expenditures: 0 percent increase
1984-1987	Current expenditures: 10 percent decrease Investment expenditures: 5 percent decrease
1988-1993	Current expenditures: 10 percent decrease Investment expenditures: 0 percent increase

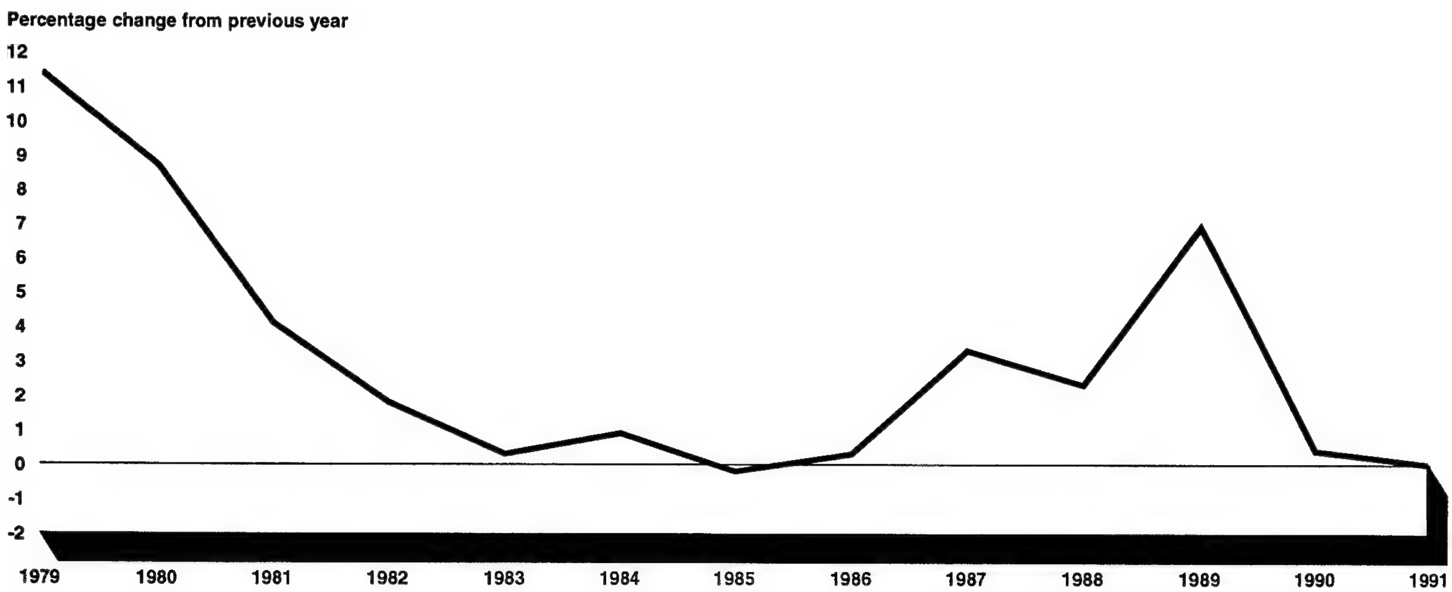
Source: The Japanese Budget in Brief, 1993.

In 1987, approximately 32 percent of general account general expenditures were subject to the ceilings; after 1987, only 11 percent was covered. General expenditures that are categorized as "exceptional" are exempt from the ceilings. These include personnel expenses, pensions, Official Development Assistance (foreign aid), energy-related measures, and enforcement of international treaties. While exceptional expenditures are exempt from the ceilings, MOF's goal has been to hold the level of all

general expenditures at or below the previous year's nominal level, and it annually determines the budget increase to apply to the exceptional expenditure total. Obligatory items such as interest subsidies and reserves are also excluded from the cutback policy.

Actual general expenditure growth within the general account budget remained below 1 percent of GNP between 1983 and 1986, as illustrated in figure IV.9, and increased at an average rate of 1.9 percent between 1987 and 1991. Inflation remained low during the 1980s, as shown in figure IV.10.

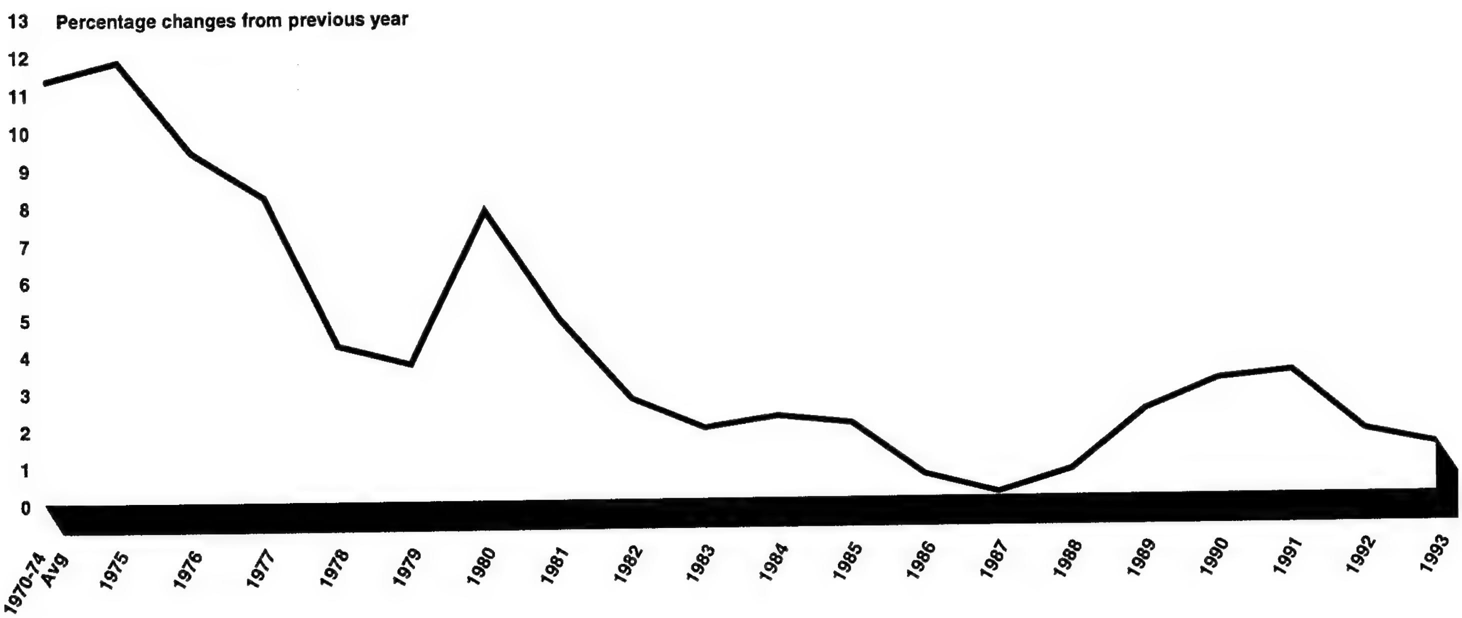
Figure IV.9: Growth of General Expenditures in Japan, 1979-1991



Note: These are actual general expenditure figures.

Source: The Japanese Budget in Brief, 1993.

Figure IV.10: Consumer Price Inflation in Japan, 1970-1993



Source: OECD Economic Outlook, #55.

- Capital spending reductions. Central government investment did not expand at all between 1981 and 1985, but as explained above, while central government investment as a share of total expenditure declined, the ratio of general government investment to gross national product did not. During the high-growth period of the late 1980s, the government began to increase public works spending to stimulate demand. In 1988, investment spending was no longer subject to nominal reductions, as were other expenditures, but was frozen, rather than reduced. Despite this commitment to capital spending, Japan is still lacking in what the Japanese refer to as social infrastructure—for example, adequate sewer services.
- Postponing payment obligations and shifting costs to other levels of government. The central government is required to distribute, through grants, a 32 percent share of estimated revenues from individual income, corporate, and liquor taxes to the local governments. In addition, the local

governments receive tax transfers and subsidies from the central government which are to be used to promote specific projects or to carry out programs on a nationwide basis.

During the 1980s, MOF postponed subsidies to local governments, along with other "exceptional measures," such as suspending obligatory payments to a fund which is used to redeem outstanding bonds. MOF also required local governments to undertake capital projects which would normally be the responsibility of the central government. This enabled the government to both lower its deficit and reduce the amount of bonds it issued.

Other deficit reduction measures included the following.

- Health insurance co-payment. In 1984, health insurance for public and private sector employees was changed from paying all costs to requiring all but the elderly to pay a co-payment of approximately 10 percent of the cost per service.
- Privatization. The Japanese government privatized three major government-owned corporations between 1985 and 1988: Japan Tobacco and Salt, Nippon Telegraph and Telephone (NTT), and Japanese National Railways (JNR). Privatization was undertaken primarily to improve the management and economic efficiency of the corporations, but privatization has also provided some short-term revenues to the government. Between fiscal years 1988 and 1991, the government earmarked $10.4 billion a year from the sale of NTT shares for public works spending. Also, proceeds from the NTT privatization were used to redeem outstanding public debt. JNR, in contrast, has a large amount of debt, and experts have stated that the government may, in the long-run, be required to cover these costs.

Reaching Agreement

Some have argued that the government in Japan was successful in promoting and carrying out its fiscal austerity measures largely because of a strong Ministry of Finance which has considerable control over the budget process, a receptive public which prefers saving to borrowing, and a business community that supported the government's deficit reduction actions.

MOF has a wide range of responsibilities and strong influence over other government organizations. According to an analyst specializing in Japan, MOF holds a combination of powers similar to those held by the Treasury,

the Securities and Exchange Commission, the Office of Management and Budget, and some aspects of the Federal Reserve in the United States. An academic stated that MOF generally has a very strong positive image in Japan, but qualified this by stating that MOF has been heavily criticized at times—for example, for inaction in response to the recession of the 1990s.

Interviewees told us that MOF was successful in implementing long-term budget reductions not only because of its authority, but also because of (1) the administrative nature of the budget process, (2) the uniformity of the expenditure ceilings, and (3) the incremental nature of the reductions under the ceilings, which did not appear to significantly affect any particular segment of the population.

MOF has minimized political debate by applying budget ceilings uniformly to each of the ministries and leaving decisions about individual programs to the relevant ministry. We were told that this type of approach can have negative as well as positive effects. For example, one economist said necessary outlays have been reduced in Japan while unnecessary ones retained. This approach also results in minimal change in the allocation of resources, as can be seen by the fact that the distribution of spending across categories has been stable since the early 1980s.

Several of the experts we interviewed stated that the public was only minimally affected by the austerity measures in the 1980s. One academic said, however, that reduced funding for education expenditures in the areas of research and construction affected the science and engineering departments of universities. An economist also said that the burden of social insurance on the public has increased.

Interviewees said that the LDP succeeded in appealing to the public's preference for savings over borrowing to convince many Japanese that deficits in the 1980s were detrimental for the country. High rates of saving in Japan suggest that the public believes it is important to save and that borrowing should be avoided. The household savings rate in Japan is very high: according to OECD data, between 1980 and 1990, it averaged 15.8 percent of disposable household income. In contrast, the household savings rate in the United States averaged 6.5 percent during the same period.

The government also worked hard to convince the public of the seriousness of the deficits. One channel that MOF used was the media.

Bureaucrats educated reporters and editors on the negative consequences of borrowing, and they passed this on to their audience.

The Administrative Reform Commission

The creation of the Administrative Reform Commission at the beginning of the 1980s led to involvement by the business community in the deficit reduction efforts of the government; this helped the government gain additional support for fiscal austerity from the general public. Interviewees said that the Commission was formed in response to pressure from the private sector, led by "Keidanren," the powerful lobby for big business in Japan. We were told that the private sector reformers preferred reduced expenditures to tax increases and wished to reduce the size of the government. The Commission was a temporary coalition between business interests and the government which advocated austerity and sound fiscal policy through deregulation, reform of the political system, a smaller government, and privatization.

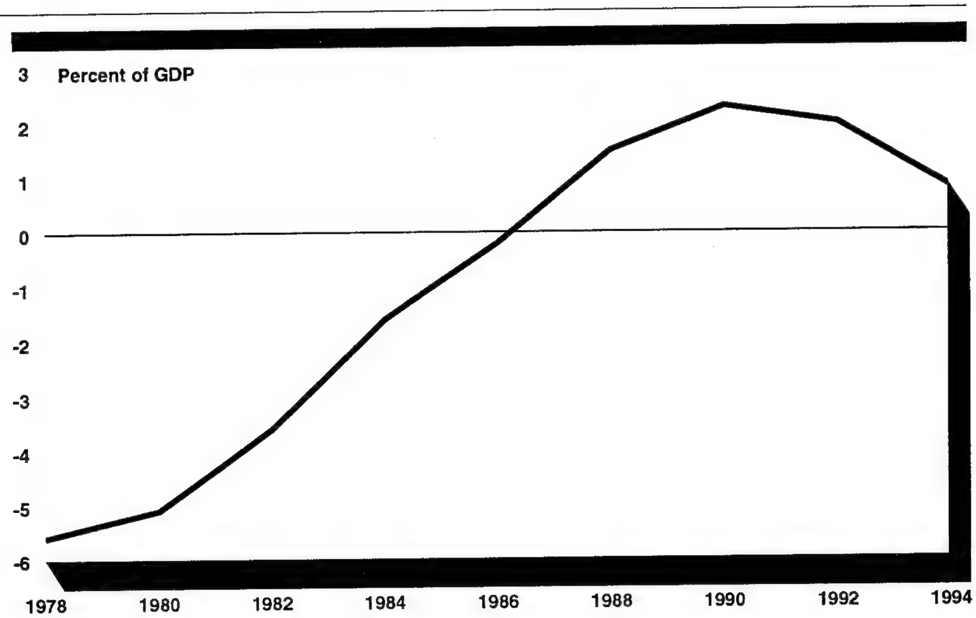
The Administrative Reform Commission succeeded in creating some consensus among the leadership; however, actual changes were relatively small. For example, although the number of government employees was reduced by approximately 3 percent at the beginning of the 1980s, by the middle of the decade, the employee level had again increased to close to its original level. MOF did not promote deregulation. Although the Commission's recommendations resulted in some privatization and reduction in expenditure growth, there was no widespread deregulation or reduction in the size of the government.

Budget Deficits During the 1990s

The tight fiscal policy of the 1980s placed pressure on monetary policy to stimulate the domestic economy. The resultant loose monetary policy and low interest rates helped create a climate for high domestic asset prices in the late 1980s and early 1990s, and what the Japanese refer to as the "bubble period." The bubble burst in the beginning of the 1990s and was accompanied by recession.

Although actual figures for 1994 were not available when we completed our work, OECD projected a general government deficit of 1.9 percent of GDP in Japan for 1994. This was the first year that general government balances were negative since 1986. OECD data also suggest, however, that the deficit is entirely cyclical rather than structural—that is, due to economic downturn. Figure IV.11 illustrates the structural component of the deficit.

Figure IV.11: General Government Structural Balances in Japan, 1978-1994



Note: Data for 1994 are based on OECD projections.

Source: OECD Economic Outlook, #55.

Observers said that MOF appears to find it crucial to support a fiscal policy that promotes balance in the general account. The inability to sustain balance has been attributed by some to a combination of the collapse of the revenue bubble and an erosion in the political consensus to continue fiscal austerity. The Japanese government is under internal and external pressure to stimulate the economy, while MOF continues to advocate continued fiscal discipline. The outlook for Japan's fiscal balance remains unclear.

Conclusion

Japan successfully reduced a significant fiscal deficit in the 1980s and sustained a budget surplus for approximately 7 years. Japan's budget is currently in deficit, but this is primarily a result of cyclical rather than structural deterioration. Observers told us that the Japanese government was able to eliminate its deficit by appealing to the underlying values of the Japanese public, taking advantage of economic growth, and implementing long-term, incremental expenditure reductions that "spread

the pain" evenly throughout the population. A strong Ministry of Finance that represented a stable government was instrumental in ensuring that policies promoting balance were undertaken in the 1980s, and MOF remains committed to fiscal balance in its tax and expenditure recommendations. Experts have noted, however, that Japan's government is experiencing a period of change and uncertainty that is unprecedented since World War II, and that, as a result, the outlook for Japan's fiscal balance is as yet unclear.

Mexico

Although its deficit reduction efforts were hampered by continuing economic troubles, a shifting fiscal policy focus, a major earthquake, and a drop in revenues due to the fall in oil prices, Mexico had a surplus in the general government[1] financial balance by 1992 and remained the only case study country with a surplus at the time we concluded our work. Mexico's success lies in turning its "vicious circle" of deficits, increasing debt and the budgetary constraints of rising interest costs into a "virtuous circle" of fiscal surplus, decreasing debt, and increased fiscal flexibility.

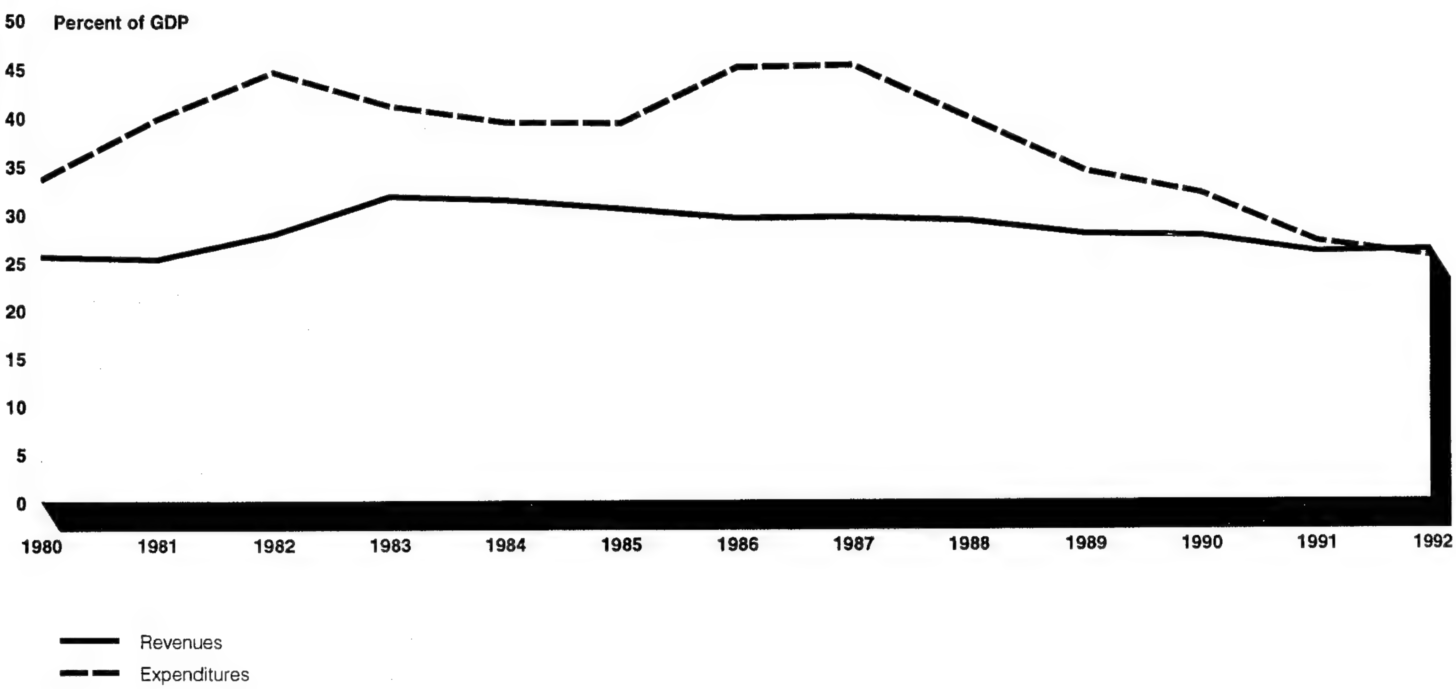
The Mexican government first adopted deficit reduction in 1983 as part of an overall plan to stabilize the economy, reduce inflation, and renew private sector and international confidence after a severe economic crisis. After a few years of limited success, the deficit grew, an economic crisis again threatened, and the government initiated a second, more successful round of deficit reduction.

The government reduced its deficit by maintaining revenues while cutting public expenditures. (See figure V.1.) The process involved spending cuts, both targeted and across-the-board, a social pact of wage and price controls to reduce inflation, large scale privatization, and debt renegotiation. Of the six case study countries included in this report, Mexico experienced the most severe economic crisis, reaching triple digit inflation and facing exclusion from international credit markets. As one government official said, "...something had to be done."

[1]General government refers to all levels of government combined. State and local governments control a relatively small portion of public sector revenue in Mexico. Therefore, this appendix will focus on data for general government.

In addition, for the other countries in this report, we relied to some extent on data from the Organization for Economic Cooperation and Development (OECD). However, since Mexico only joined OECD in early 1994, OECD data were not available. Data for this appendix were primarily from the Banco de Mexico, Mexico's central bank.

Figure V.1: Budgetary Public Sector Revenues and Expenditures in Mexico, 1980-1992



Source: Banco de Mexico.

Background

Mexico is a federal republic with an executive, a legislative, and a judicial branch. The executive branch, headed by the President, promulgates all laws and essentially controls the distribution of federal revenues. Presidential elections are held every 6 years. The executive branch also includes the central bank, Banco de Mexico, although a constitutional amendment was implemented on April 1, 1994, to make the central bank more independent of government control.

Mexico's legislature is made up of an elected Senate (64 members) and Chamber of Deputies (500 members) whose membership is determined by a mix of majority vote and proportional representation of minority parties. The Mexican public sector includes the federal government, the state and local government (including the federal district encompassing Mexico City), and public enterprises. Eleven public enterprises were still under budgetary control in 1994, including the national oil company (PEMEX) and the Federal Electricity Commission.

The two primary political parties in Mexico have historically been the predominant Institutional Revolutionary Party, or PRI, and the National Action Party, or PAN. PRI has had a monopoly on presidential power, although in 1988 an opposition candidate from the National Democratic Front, representing a coalition of smaller parties, won a significant portion of the popular vote. However, PRI retained the presidency and control of the Congress. PRI again won the presidency in the 1994 election. PAN has reasserted itself as the main opposition party, but opposition parties do not seem to play a major role in policy-making at this time. However, rising social unrest was evident in early 1994 in Chiapas, Mexico. This may change the political bargaining power of opposition groups in the future.

Budget Process

The Mexican Secretariat of Finance and Public Credit in the executive branch of government largely controls the federal budget. For the most part, budget decision-making is a top-down process controlled by the Secretariat, which develops the budget, shares it with the other secretariats, and presents it to the Congress. The public enterprise budgets subject to government control are developed independently and must be approved by a board of directors composed of officials from relevant secretariats. The federal budget is debated to a limited extent in the legislature and usually is passed as presented. According to one official, the legislature first added programs which had not been included in the proposed budget in 1992. No recent budget process reform has taken place.

Budget Structure

The Mexican budget is composed of programmable and nonprogrammable expenditures. Expenditures completely controlled through annual appropriations by the federal government, including the budgets for public enterprises, are considered programmable. Nonprogrammable expenditures are those expenditures over which the central government has no control, such as revenue sharing to the states, which is determined by formula, and interest payments.

Social spending does not play as large a role in the Mexican budget as it does in the other countries in this study. Social spending represented about one third of programmable spending and one quarter of total spending in 1980. The social security system is relatively limited and was not identified as a deficit driver by most interviewees. One budget expert suggested that the social security system could be considered a deficit driver if one considers the potential liabilities it may face in the future.

Health care, pensions, and other social services, known in Mexico as "social security" are primarily provided to workers and their families through a complex series of government, union, and private sector institutes, each with their own range of benefits and eligibility. The institutes are funded jointly by employees, employers, and the government. There is no national agency that coordinates or supervises all the existing social security institutes, funds, or programs. In 1992, the Mexican government established a Retirement Savings System to provide pensions and limited unemployment, disability, and housing construction assistance. This is financed by taxes on employers and voluntary employee contributions and replaces some aspects of the previous social security structure.

According to interviewees, Mexico has no large entitlement programs or comprehensive social safety net. Extended families furnish a safety net for upwards of one third of the population due in part to the limited social security system and limited unemployment compensation. Interviewees said public expectations are low for the social security system. Many individuals eligible for the public system choose private health care, and pension payments have been eroded over time by inflation. One interviewee suggested that this situation represents a significant transfer of responsibility between the public and private sectors, allowing the government to continue reducing its social benefits.

State and Local Governments Have Limited Responsibilities

The federal government is responsible for all major public sector functions in Mexico. In the mid-1980s, the federal authorities accounted for some 72 percent of general government expenditure (including public enterprises), the 31 states and the federal district accounted for 23 percent, and the local authorities for 5 percent. Most expenditure at the state and local levels, however, comes from federal revenue sharing. States turn over the majority of their tax revenue to the federal government, and in return receive federal transfers. In 1992, these transfers amounted to around 20 percent of total federal expenditure, almost double the percentage state and local governments received in 1988. The increase in revenue sharing is due to the improved financial situation of the federal government and the move to decentralize some public services. Local agencies depend on state agencies for funds, which in turn depend on the federal government. Federal agencies own and supervise large public enterprises, whereas state and local governments manage mostly small utilities and other service operations.

Defining Budget Balance

The primary balance and the financial balance, or Public Sector Borrowing Requirement (PSBR), are two commonly used measures of budget deficits in Mexico.[2] The financial balance represents the difference between total revenue and total expenditure of the general government and thus the effect of the deficit or surplus on the economy. For Mexico, the PSBR shows a deficit of 16.9 percent of GDP in 1982 and approximate balance in 1992. All further references to deficits in this appendix refer to the PSBR.

The primary balance represents the overall public sector balance excluding interest, revenue sharing to states, and net transfers to entities not under budgetary control, which according to a budget expert, currently represent 10 public enterprises or institutions, such as the National University. As shown in table V.1, under this measure, the Mexican government had a deficit of 8.0 percent of GDP in 1981 but achieved a surplus of 4.2 percent of GDP by 1983.

Table V.1: Public Finance Indicators as a Percent of GDP in Mexico

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Primary balance	–3.0	–8.0	–7.3	4.2	4.8	3.4	1.6	4.7	8.0	7.9	7.8	5.3	5.6
PSBR	–7.5	–14.1	–16.9	–8.6	–8.5	–9.6	–16.0	–16.0	–13.0	–5.6	–3.9	–1.5	0.5

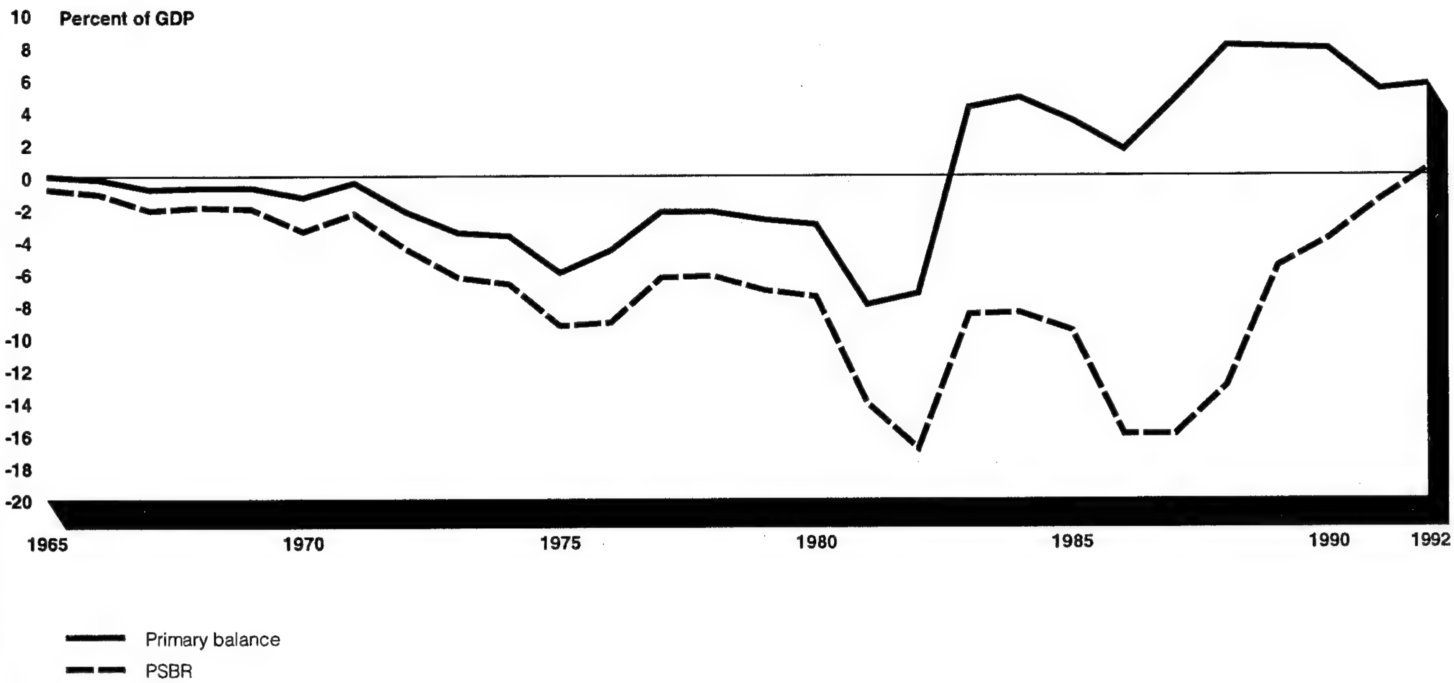
Note: Data for 1991 and 1992 exclude privatization proceeds.

Source: Banco de Mexico.

Figure V.2 shows these two indicators over a 28-year period. The difference between the two approximates interest payments, federal revenue sharing, and transfers to entities not included under budgetary control.

[2]Privatization proceeds are usually included in both measures. However, the most recent years' data are reported without fully accounting for privatization proceeds, perhaps because the sale of a large asset can take several years.

Figure V.2: Public Finance Indicators in Mexico, 1965-1992



Note: Data for 1991 and 1992 exclude privatization proceeds. Data for 1992 are preliminary.

Source: Banco de Mexico.

Impetus for Deficit Reduction

While economic pressure, in combination with a change in political parties or political philosophy, played a role in the other five countries we examined, only Mexico adopted deficit reduction solely in response to an economic crisis. Two distinct phases characterize Mexico's deficit reduction. The first was a response to the 1982 economic crisis, when a series of adverse events culminated in the refusal of international banks to roll over short-term credit. The second phase of deficit reduction responded to the failure of initial austerity policies to alleviate the economic troubles, such as high inflation and stagnating growth, that persisted through the mid-1980s. The following sections describe the development of Mexico's deficits and how government action was prompted in 1982 and again in 1987.

Deficits Started in Response to 1970s Social, Political Unrest

Mexico's leaders first built up deficits in the late 1960s and throughout the 1970s in efforts to maintain political popularity, but they were rapidly increased by a slowing economy, patterns of high spending built on expectations of continuing oil revenues, and the willingness of foreign banks to finance the deficit.

At the end of the 1960s, Mexico had a 30-year tradition of stable government and high economic growth (6.8 percent annual average). In 1968, however, the situation changed. Student riots caused concern about the stability of the political system. When President Luis Echeverria came to office in 1970, government policy responded to the new social demands for both economic growth and income redistribution with increased public spending. One analysis of this time stated that rather than choosing or discriminating among various investment projects, the Echeverria government spent on all of them.[3] A budget expert in Mexico stated that a proposed tax reform plan to pay for the investment spending was never approved. The high public spending resulted in growing deficits throughout the 1970s, financed by both domestic and foreign debt, and contributed to rising inflation.

Under Lòpez Portillo (1976-1982), Mexico's budget deficit initially stabilized but high government spending returned with high oil revenues, as the economy grew over 8 percent annually from 1978 to 1981. Although oil revenues then started to decline, the expansion of government continued. Portillo tried to maintain the high level of economic activity by relying on increased foreign borrowing.

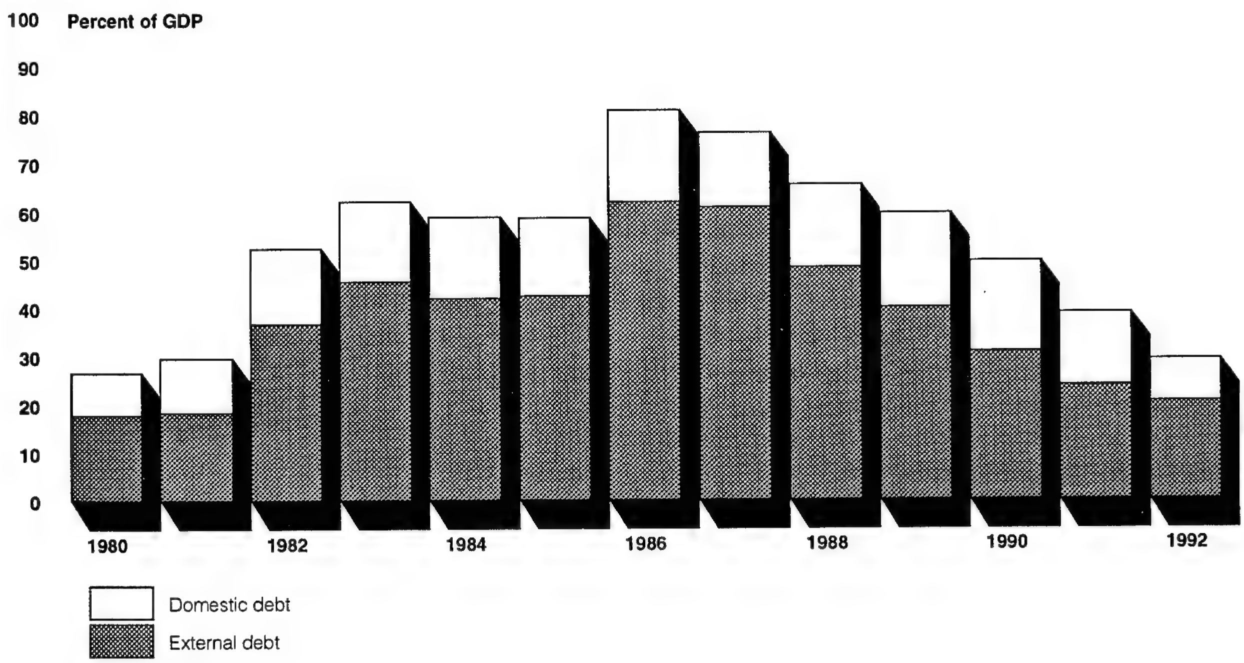
High Debt Fostered Spiraling Deficits

Heavy reliance on debt for public sector financing clearly had a negative impact on Mexico's financial stability. The size of Mexico's public debt, from both domestic and foreign sources, and how it was financed greatly affected the deficit situation in Mexico.

Starting in the early 1970s, foreign borrowing became one of the major sources of government financing, primarily due to the rapid growth in government spending, which domestic savings were unable to finance. External borrowing was facilitated by the willingness of international banks to provide resources. As seen in figure V.3, external debt grew until 1987.

[3]Luis Rubio F. and Francisco Gil-Diaz, A Mexican Response (New York, N.Y.: Priority Press Publications, 1987), p. 18.

Figure V.3: Total Net Debt of the Public Sector in Mexico, 1980-1992



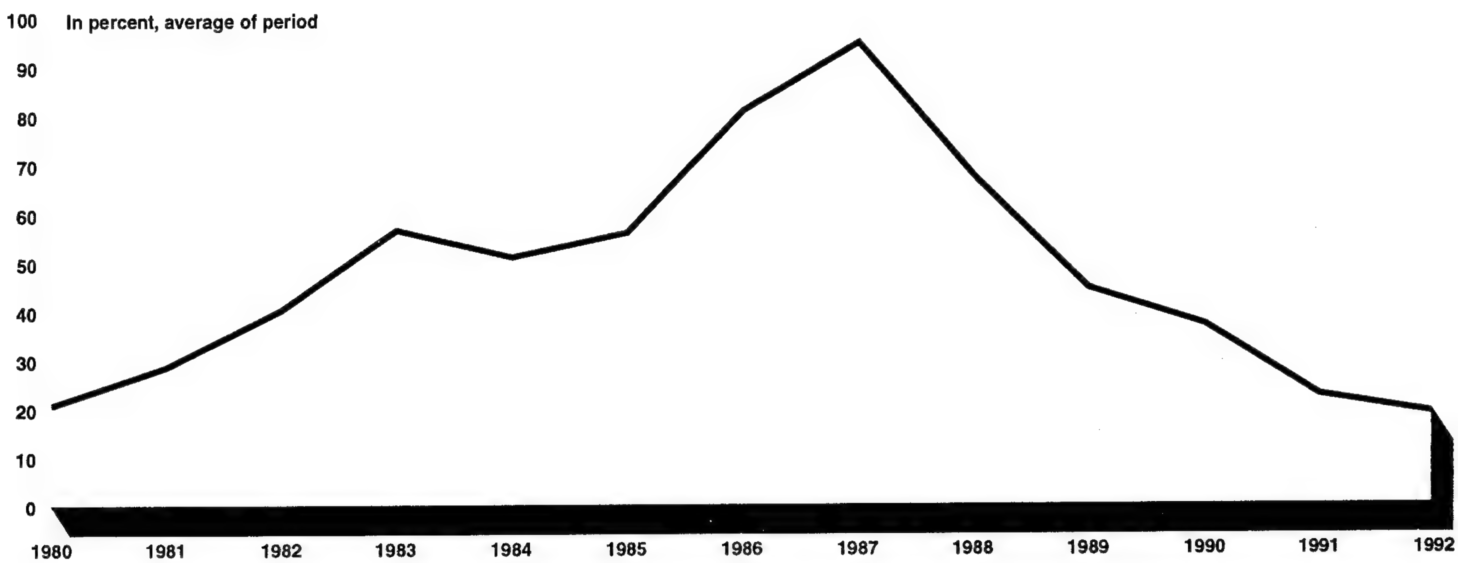
Note: Data include debt incurred by the federal government, government enterprises and entities, development banks, and official trust funds. Data for 1992 are preliminary.

Source: Banco de Mexico.

Interest Payments Became Deficit Drivers

The composition of the public debt made the situation worse. By 1982, short-term debt (with maturity of less than 1 year) rose to one third of total debt outstanding. This made the Mexican economy vulnerable to adverse economic developments that occurred in the international community, such as the sharp increase in international interest rates. With high interest rates, high inflation, and deteriorating confidence in the Mexican economy, the costs of debt servicing increased through 1987, even in the face of tighter fiscal policies. Interest payments became the primary "deficit driver." (See figures V.4 and V.5.)

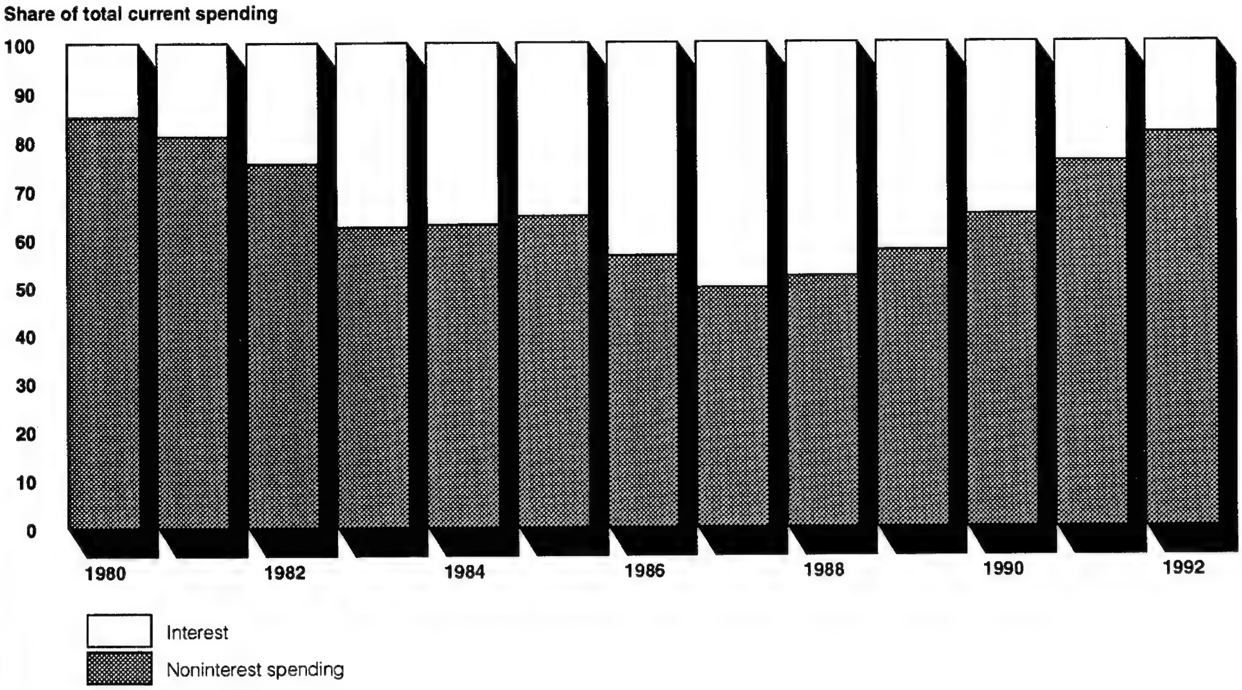
Figure V.4: Interest Rates in Mexico, 1980-1992



Note: Data represent the average cost of term deposits for banks.

Source: Banco de Mexico.

Figure V.5: Share of Interest in Total Current Spending in Mexico, 1980-1992



Note: Data for 1992 are preliminary.

Source: Banco de Mexico.

Oil Revenues Postponed Action on Deficit

The changing price of oil also strongly affected the deficit situation in Mexico, prompting increased public sector spending when high and reducing government revenue when low. Oil has played a major role in government policy-making in Mexico since the beginning of the Portillo administration (1976-1982), when the government confirmed the existence of large oil deposits. Oil revenues were approximately one third to one half of total budgetary public sector revenue between 1980 and 1990.

One analysis of the Mexican economy states that the discovery of the oil deposits and the large oil price increases in the late 1970s postponed a true fiscal adjustment after Mexico's economic troubles in the mid-1970s.[4] The government's annual revenue law has a specific section for PEMEX, although it is not subject to the regular tax system. As described by a

[4]Luis Rubio F. and Francisco Gil-Diaz, A Mexican Response, pps. 13 and 14.

budget expert, PEMEX serves as a type of franchise operation that pays the government for oil extraction rights. PEMEX transfers approximately 50 to 60 percent of its revenues to the government each year.

From 1981 to 1985, average export oil prices fell from over $33 per barrel to $25.50 per barrel. However, the most dramatic impact of oil prices came in February 1986, when oil prices dropped below $10 per barrel. Although the price of oil rose again in the second half of the decade, the severe drop in oil prices and the corresponding stress it placed on government revenues in 1985 strengthened the view that fundamental changes in the Mexican economy were needed. Fluctuating oil prices contributed to the economic crisis that served as the impetus for deficit reduction.

1982 Economic Crisis Forced Government Action

As declining oil revenue increased the fiscal deficit, the government began to rely more on foreign debt to finance the fiscal gap. Domestic savings could not finance the deficit because individuals with mobile capital were nervous about the economic situation, and capital flight occurred—investors sent capital out of the country, draining available resources for government borrowing. When international banks refused to roll-over short-term credit, Mexico no longer had access to international credit markets and thus could no longer finance its deficit. Under the circumstances, Mexico was forced to adopt a deficit reduction policy immediately.

An overvalued peso had exacerbated the problem. Up to 1982, the Mexican government was reluctant to devalue the peso. With financial markets believing that the peso was overvalued and that devaluation was imminent, capital flight and deposits in dollar-denominated accounts increased. The impact of capital flight on growth was not perceived to be severe until Mexico's access to international credit was restricted in 1982. Capital flight coupled with lack of international credit reduced funds available for economic growth. In response to these pressures, the government devalued the peso twice in 1982.

Since government spending financed by foreign debt could no longer support economic growth, the Mexican economy went from growth rates of over 8 percent for the previous 3 years into recession. In September 1982, private banks were nationalized and exchange rate controls introduced. Inflation reached triple digits (a then-historic high of 117 percent per annum in April 1983), and Mexico announced it was suspending payments due on its foreign debt.

1987 Record Inflation Triggered Renewed Deficit Reduction Efforts

The Mexican government was compelled to address a large deficit in the second half of the decade as well. Austerity measures described below were implemented by President de la Madrid's administration when he took office in 1982. However, after some success in 1983, the deficit returned to 16 percent of GDP by 1986. Analysts report that the public's perception that the size of the public debt and the continuing economic crisis were related became a major source of support for the second phase of deficit reduction. Officials said the public realized the depth of the economic crisis when inflation again reached triple digits after several years of austerity. The public understood that the fiscal problems were structural and would not be solved with short-term policies. People we interviewed said the short-term solutions had not worked and the economic situation was worse. At one point in 1987, the annual inflation rate was about 200 percent. Sky-rocketing inflation, illustrated in figure V.6, was the trigger for renewed efforts to reduce the deficit.

Figure V.6: Consumer Price Inflation in Mexico, 1978-1990

Source: Mexico: The Strategy to Achieve Sustained Economic Growth, International Monetary Fund, 1992.

Deficit Reduction Actions

Mexico adopted deficit reduction in 1982 as part of an overall plan to stabilize the economy, reduce inflation, and renew private sector and international confidence. The deficit was eliminated by 1992 by maintaining revenue levels while cutting expenditures. The largest savings came from debt renegotiation, which reduced interest costs, and the privatization of money-losing nationalized industries. The process also involved government spending cuts, both targeted and across-the-board, and an increase in revenues from enhanced income tax enforcement and increases in prices on goods controlled by the government, such as electricity.

The government pursued deficit reduction in two distinct periods in the 1980s. The first phase, 1983 to 1984, focused on short-term efforts, but faltered after an impressive first year. In 1985 and 1986, the deficit again increased. President de la Madrid shifted the policy focus in 1987 to a more structural, long-term approach. President Salinas (1988-1994) continued this approach, and from 1988 the deficit declined rapidly, until surplus was reached in 1992. Because of their different natures, the period before the economic crisis of 1987 and the period after are discussed separately below.

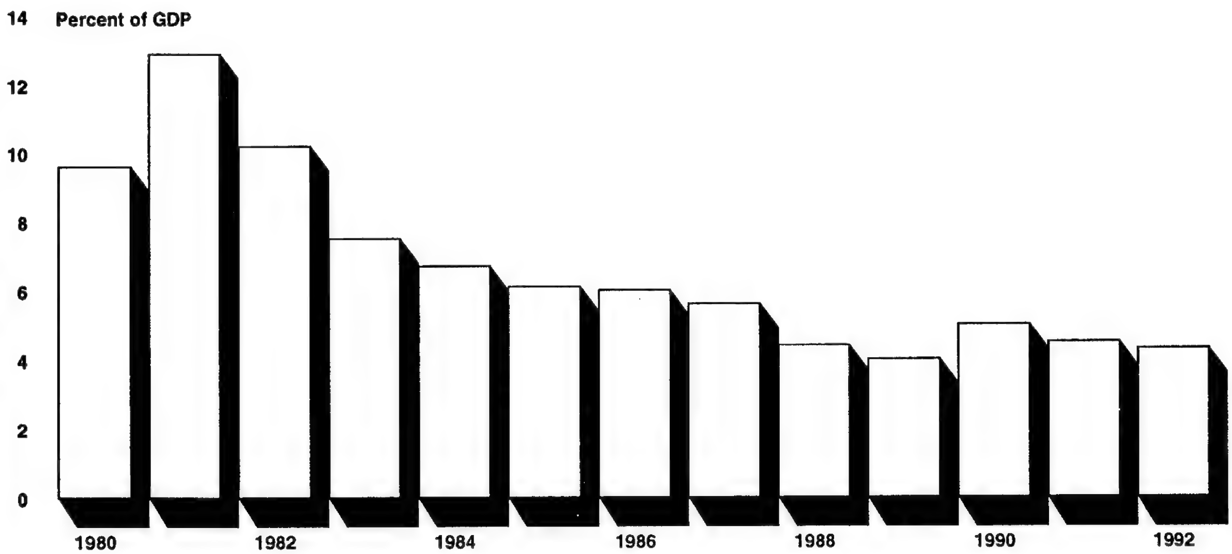
1982-1986: Plans for Economic Stability

In 1982, the new de la Madrid administration started deficit reduction under the Program for Immediate Economic Reordering; two of its goals were lowering inflation and cutting the deficit to 3.5 percent of GDP by 1985. The program was successful in achieving its first year's reduction targets, but then lost momentum. Although revenue was raised through tax and public-good price increases, the majority of fiscal adjustment came from the spending side of the budget, cuts in investment, lower real wages, and some trimming of the public sector. Total noninterest public sector outlays, including investment, were reduced in real terms by 11 percent in 1983. The International Monetary Fund estimates that revenue contributed only 1.5 percentage points to the 10 percentage points of adjustment in the primary deficit (total deficit excluding interest payments) between 1982-1987. The following provides details on deficit reduction actions.

- Investment. Public investment was the major casualty of the cuts in spending over the 1980s, particularly in the first half of the decade. As shown in figure V.7 and table V.2, capital expenditure was more than halved as a percent of GDP between 1982 and 1991. Non-oil investment as a proportion of GDP reached its lowest level since World War II. Capital

maintenance was also severely neglected, especially for roads, sewers, and water systems.

Figure V.7: Capital Expenditures in Mexico, 1980-1992



Note: Data for 1992 are preliminary.

Source: Banco de Mexico.

Table V.2: Investment Spending in Mexico, 1982 and 1991

Consolidated public sector expenditures	1982	1991	1991 as a percent of 1982 expenditure
Capital expenditure	10.5	4.4	42
Public enterprises (excluding PEMEX)	2.5	1.3	52
PEMEX	2.9	0.9	31
Federal government	5.1	2.2	43

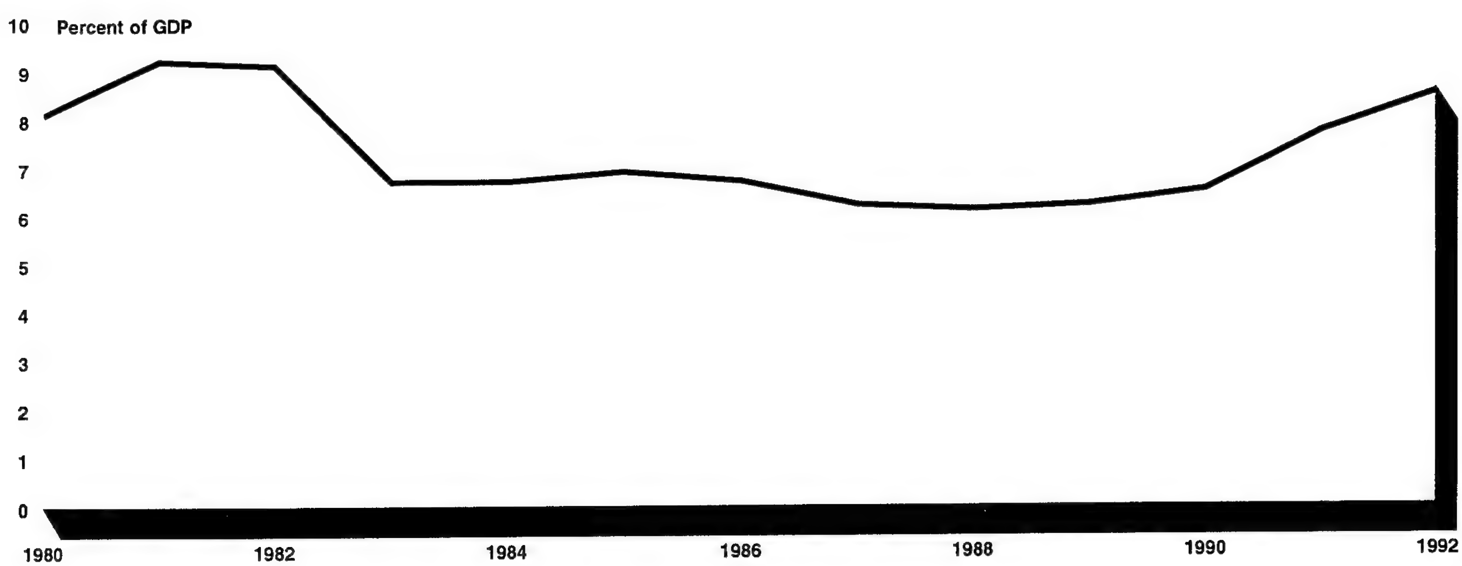
Source: OECD Economic Survey, Mexico: 1991/1992, p. 130.

- Public sector wages. The government held public sector wages below inflation by tying wages to a target inflation rate rather than to past price increases. Not only did this reduce real wages, but it attempted to reduce

self-fulfilling inflationary pressures. Between 1982 and 1988, federal government salaries dropped by around 50 percent in real terms. Wages in public enterprises fell by 30 to 35 percent in real terms. Over the decade, the federal government wage bill as a percent of GDP was cut by 20 percent.

- Cuts in programs. Government officials and policy analysts, while acknowledging that deficit reduction included important spending cuts overall on discretionary-type programs, overall did not feel that specific programs were targeted for cuts. Spending reductions included lower personnel costs, and sometimes across-the-board reductions. Throughout the 1980s, social spending's share of both programmable and total spending dipped and then rose, reflecting strict spending policies during the middle of the decade and a re-emphasis on social spending at the end. Social spending contracted early in the decade. However, social spending was increased at the end of the decade in line with the Salinas' government increased emphasis on social welfare.

Figure V.8: Social Spending in Mexico, 1980-1992



Note: Social spending includes education, health, and the Solidarity program, which provides grants to low-income communities.

Source: Coordinador de Asesores Economicos.

- Tax increases. Direct and indirect taxes were increased during this time. Measures included raising the value-added tax (VAT) rate to 15 percent from the previous rate of 10 percent, applying a 10 percent surtax to all taxpayers who earned more than five times the national average minimum wage, and eliminating tax exemptions for gasoline stations, transportation, and wood-using industries.
- Public sector price increases. The government reduced subsidies to bring publicly administered prices in line with production costs or international prices. Items supported by general food subsidies included bread, tortillas, beans, eggs, milk, and cooking oil. The price for these items is set by the government and the producer is provided with subsidized inputs. The government eliminated or reduced some of general subsidies to both the public and industry. In 1982, subsidy reduction resulted in price increases of 100, 50, 30, and 12 percent for bread and tortillas, gasoline, electricity, and natural gas respectively. Although subsidies overall were cut, some subsidies were replaced with more targeted programs.

The 1987 Economic Crisis

The economic stability hoped for at the start of this process had not been achieved by 1985. The PSBR was reduced by 8.5 percentage points of GDP in the initial year of the program, but other economic targets set by the government were not achieved. Output contracted rather than stabilized, and inflation did not fall as expected. The deficit as a share of GDP started to rise again and financial markets grew increasingly nervous—capital flight continued, the peso declined, and inflation accelerated.

In 1985 and 1986, an earthquake and a drop in oil prices made continuing deficit reduction difficult. A major earthquake hit Mexico City in 1985, making budget plans obsolete. Then oil prices collapsed in 1986, dropping more than 50 percent. The loss in oil revenues was 4 percent of GDP, at that time about a 13-percent reduction in public sector revenues. Interest payments continued to absorb a significant portion of the budget. Inflation again accelerated, and the government financed its deficit by forced borrowing from the nationalized banks at artificially low interest rates. By 1986, Mexico again had trouble servicing its debt. Confidence in the Mexican currency suffered again, triggering another massive outflow of capital, when the world stock market crisis of October 1987 caused Mexican stock market prices to collapse.

1987-Present: Successful Deficit Reduction

The year 1987 marked a shift in policies to address the deficit and stabilize the economy. The government, facing a second economic crisis, decided

that a significant policy shift was necessary to break the cycle of credit market pressure and triple digit inflation, and adopted different deficit reduction measures. While it is difficult to determine the relative impact of the measures, the most important included debt renegotiations, the Pact of Economic Solidarity agreement (commonly known as PACTO), increased privatization, continued cuts in government spending, tax reform and stronger tax enforcement, and continued increases in public sector prices. Unlike other countries in this study, Mexico did not cut transfers to states. In fact, between 1983 and 1990, transfers under the revenue-sharing arrangement rose by about 40 percent as a share of GDP. The following provides details on deficit reduction actions taken during the latter half of the 1980s.

- Debt renegotiation. Throughout the 1980s, Mexico was able to renegotiate its debt to ease the pressure of interest payments, but significant savings did not occur until the second half of the decade.

  Interest payments on the public debt comprised the largest single spending reduction in the Mexican budget in the second phase of deficit reduction. One former government official described this as a result of turning the "vicious circle" of deficits adding to debt and increasing interest payments into a "virtuous circle" of paying off debt and reducing interest payments. From a high of 19.6 percent of GDP in 1987, interest payments dropped to 3.9 percent of GDP in 1992. Of the total difference in public expenditure between 1987 and 1992, 18.7 percentage points of GDP, interest payment cuts represented 15.7 points.

  The drop in interest payments was due to debt renegotiation, lower interest rates as confidence in the Mexican economy improved, and debt repayment when the budget finally reached a general government surplus. Through a variety of mechanisms, debt renegotiation packages sought to improve the terms and payment profile of public debt. One package, the 1989 Brady Plan, resulted in the cancellation of $14 billion, or 15 percent of the face value of gross foreign debt.

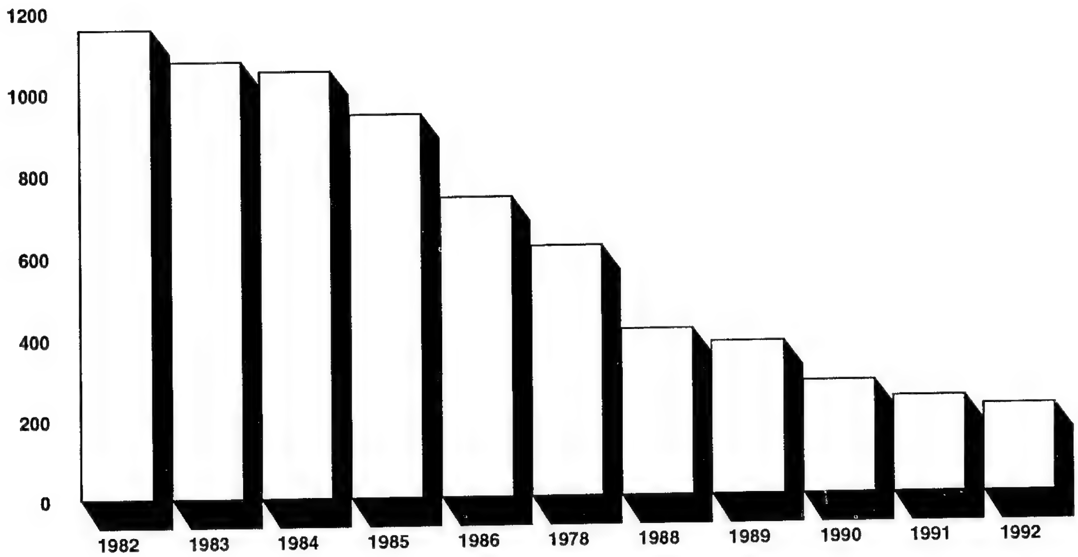
  In addition, the agreements greatly enhanced the credibility of Mexican policy in the eyes of foreign creditors and the public in general. Interest rates fell by more than 30 percentage points in one year (see figure V.4), lowering the burden of annual interest payments. When Mexico's deficit was finally eliminated in 1992, the growth of the debt, and any resulting increase in interest payments, was reversed.

- PACTO. In 1987, the government initiated the Pact of Economic Solidarity, a renewable wage and price agreement with leaders of the main sectors of the economy (labor, agriculture, and business) with the objective of curtailing inflation without causing a recession. Although the focus was broader than just deficit reduction, interviewees consistently described PACTO as being essential to the government's success in deficit reduction.

  The PACTO agreements outlined the actions to be taken by both the government and the private sector. All parties agreed to a target inflation rate. As part of the PACTO agreement, on the public sector side, government continued to increase publicly administered prices and implement additional structural reforms. For example, in 1987, prices for energy, fertilizers, steel products, and sugar increased 85, 82, 33, and 81 percent, respectively, while train tariffs and telephone fees increased by 17 and 81 percent, respectively. On the private sector side, business agreed to control prices and workers agreed to accept constrained wages. The parties have renewed the PACTO, with similar measures, numerous times since.

- Privatization. Large scale privatization was an important part of deficit reduction and the redefinition of the public sector. The government's privatization program was intended to both raise revenue and reduce the role of government, thereby increasing economic efficiency. It involved the closure of unprofitable plants and businesses and the privatization of others. Although the major privatizations did not occur until 1988, the closing of unprofitable enterprises saved money throughout the decade. From 1983 to 1985, small, nonviable enterprises were merged or closed. From 1986 to 1988, small- to medium-sized firms were sold. Between 1982 and 1992, the government closed, sold, or merged 1,008 out of 1,155 public enterprises. Mexico includes revenues from privatization in its estimation of PSBR. Revenue from privatization equaling 6.3 percent of GDP has been realized since 1989.

Figure V.9: Number of Public Enterprises in Mexico, 1982-1992



Source: Banco de Mexico.

One official told us that the initial slow pace of privatization was deliberate—Mexico wanted to learn from the experience of other countries undergoing the same process. This allowed the government to gain experience and build political and domestic and international business confidence. Along with privatization, the government pursued deregulation, achieving savings in the process by eliminating government offices and staff.

In December 1990, with proceeds from the privatization of the Mexican telephone company, the government created the Contingency Fund with the purpose of protecting the economy from a possible drop in oil prices following the Persian Gulf conflict. The fund subsequently received proceeds from other public enterprise sales, based on the belief that one-time revenues should be set aside as reserves to face external shocks or to cancel public debt. Since September 1991, resources from the Contingency Fund have been used to pay back public debt, rendering a permanent benefit to public finances.

- Further cuts in overall government spending. As seen in table V.3, government spending was constrained in the 1980s. Government expenditure (excluding interest) as a whole was cut dramatically, although interviewees did not identify specific programs or budget areas (other than investment) that had been targeted for cuts. As mentioned above, it appears that reductions were mainly achieved through across-the-board cuts and reductions in personnel and real wages. As shown in table V.3, all levels of government cut public current expenditures (as opposed to capital). Part of the drop in spending for public enterprises may be due to the privatization that occurred throughout the 1980s.

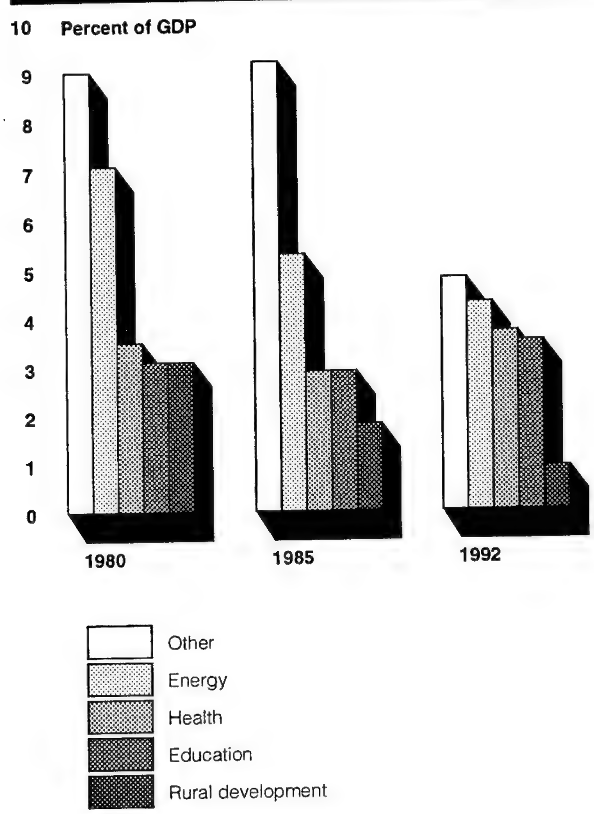
Table V.3: Noninvestment Public Sector Spending in Mexico, 1982-1991

Consolidated public sector expenditures	1982 (Percent of GDP)	1991 (Percent of GDP)	1991 as a percent of 1982 expenditure
Current noninterest expenditure	27.5	17.2	63
Public enterprises	8.4	4.3	51
General government	19.1	12.9	68
Federal government	13.5	10.0	74
State/local government	5.6	2.9	52

Source: OECD Economic Survey, Mexico: 1991/1992, p. 130.

As seen in Figure V.10, within the overall reductions, the government took care to preserve or shift funding to health and education. Some funding for rural development may have been switched to the smaller Solidarity program, a program of development grants and government assistance for low-income areas. While the overall volume of subsidies declined, the remainder was increasingly focused on health, education, and basic food supply: the share of these items in total transfers rose from 31 percent in 1983 to 51 percent by 1990.

Figure V.10: Programmable Spending in Mexico in Selected Years



Note: Other represents expenditures for fishing, communication, transportation, commerce, tourism, industry, administration, justice and security, the Solidarity program, and other small programs.

Source: Coordinador de Asesores Economicos.

- Taxes. A major reform of the tax system took place in 1987. This was in response to revenue shortfall from the oil price collapse in 1986 and the erosion of real personal and corporate income tax revenues by rapid inflation due to collection lags. Mexico changed its tax system in three major ways: (1) it increased enforcement on both the personal and corporate levels, (2) it eliminated major tax breaks, such as exemptions for the agricultural and transportation sectors, and (3) it simplified and reduced rates while widening the tax base. As shown in table V.4, although overall revenues have not dramatically increased as a share of GDP, the

share of public sector revenue from PEMEX, other public enterprises, and the federal government tax system has shifted.

Table V.4: Shifts in Public Sector Revenue Sources in Mexico

	Shares of total public sector revenue		
	1982-84	**1985-87**	**1988-91**
PEMEX	39	33	26
Other public enterprises	18	21	18
Federal and other taxes	43	46	56
Total	**100**	**100**	**100**

Source: OECD Economic Survey: Mexico, 1991/1992, p. 134.

Although tax reform has incorporated rate changes and base broadening, numerous officials said increased tax enforcement represented an important tax-related element of deficit reduction. Income tax evasion used to be a common occurrence, and officials said corporate tax was often not paid. A series of highly visible actions led the way for increased enforcement, including the arrest of several high-profile people, including a union official, for tax evasion. In another example, to increase corporate tax compliance, the government implemented a 2 percent tax on all business assets, which could be deducted from corporate income tax. The new tax served to bring more businesses into the tax system.

Reaching Agreement

The same political party, the PRI, has been in power in Mexico since 1929, even in the face of a significant political challenge in the 1988 elections and social unrest in early 1994. The 1987 economic crisis, however, forced the government to pursue deficit reduction as a means of breaking spiraling inflation. The government gained support for this in ways that involved working with all the affected groups—through the PACTO agreements, trade-offs to protect constituents, and expanding traditional political power bases.

Public Perception of Crisis Important

As described previously, a crisis atmosphere is credited with motivating the Mexican government to make structural changes to reduce its deficit and with making the general population understand that deficit reduction was necessary. One official said it is easy to promote deficit reduction when you have triple-digit inflation.

Interviewees said public support was very important to Mexico's deficit reduction actions. The 1982 crisis occurred in the same year that a new administration took office. Domestic and international confidence in Mexico's ability to manage its economy had eroded. The government saw rebuilding this confidence with prompt action to reduce the deficit as a necessary ingredient to successfully stabilizing the economy.

The perception of the problem's depth, however, distinguished the second deficit reduction phase from the first. The first stage was characterized by the conditions under which it was adopted—as a result of a major economic crisis—and the seemingly short-term focus of the solution. Although there was a severe economic crisis, most Mexicans believed that there would be some years of austerity, after which austerity would end and growth would return. Current and former government officials said structural changes, rather than holding down wages, employment, and investment spending, were not considered until the second phase when it was clear that the economy was not responding to short-term policies.

PACTO Built on Consensus and Credibility

In part, expectations and a lack of national and international confidence in the government's ability to control the economy drove high inflation. The drive to break inflationary expectations and rebuild confidence is best exemplified in the PACTO agreements. These agreements were a particularly important factor to the public's acceptance of deficit reduction.

The government emphasized consensus building and consultation with the PACTO agreements. PACTO members, representing both the public and private sectors, agreed to a target rate of inflation and indexed wages and prices to that target rate. Members agreed to meet periodically to examine compliance with the agreement and to discuss economic goals and further measures to be taken. Analysts said credibility in the PACTO agreements and among its members was established gradually.

With PACTO, the government used the idea of shared sacrifice and commitment to garner support for a joint effort from both the public and private sectors to reduce inflation. Part of the success of PACTO came from the atmosphere of economic crisis existing at the time. The government's willingness to absorb cuts also made it easier to sell austerity to the public.

Even before PACTO, policy-making involved consensus building. Unions play a strong interest group role in Mexico, although their role has been

diminishing. They traditionally support government policy and value cooperative relationships with the executive branch. Our interviews indicated that other organized interest groups, labor unrest, and political opposition did not play a visible role in influencing government policy, except perhaps in pressure for social spending in the 1970s and in strengthening political opposition in the 1988 election.

The relationship between PACTO and the government's deficit reduction goals was mutually beneficial. For PACTO to be successful, the government needed to keep its commitment of reducing the public sector budget. At the same time, by agreeing to keep wage and price growth low, business and labor helped dampen inflation. The initial and subsequent PACTO agreements' success in bringing down inflation helped to stabilize the economy, thus creating a better atmosphere for debt renegotiation, increasing domestic and international confidence and investment, and lowering interest rates and debt-servicing pressure on the budget.

Some Constituencies Were Relatively Protected From Austerity Measures

The Mexican government used trade-offs to help gain acceptance of deficit reduction and alleviate the effects of some of the resulting austerity measures. As mentioned previously, the government took steps to replace certain general subsidies with targeted ones. For example, in 1984, the government eliminated the general subsidy for corn tortillas, but over the next several years, replaced it with other programs whereby low income groups could receive discounts on or free tortillas. Although spending on the targeted subsidies rose in 1988 and 1989 as a result of the PACTO agreements, total spending on general food subsidies distributed through the public sector's food distribution chain declined in real terms.

Interviewees said that the government worked to gain support and to lessen opposition. For example, since privatization was politically and ideologically sensitive, the government moved slowly, closing smaller firms first. In addition, the government worked with unions to protect employment levels by seeking wage reductions rather than staff cuts as a way to reduce personnel costs. Many of the people we interviewed, including a union official, emphasized the importance of this trade-off to the acceptance of government policies at the time. Since the government did not provide any unemployment insurance, people prefer employment, even at lower wages, over increased or stable wages with fewer jobs.[5]

[5]This may account for the relatively low unemployment rate, which fluctuated between 2.7 and 6.1 percent between 1980 and 1991.

In the late 1980s, President Salinas instituted programs responsive to the rural and urban poor. Salinas instituted the Solidarity program, a development grant program targeted to extremely poor areas. The program is highly popular with the electorate. Salinas also pointed to his administration's success in achieving its stated economic targets. One government official said the population needed to see that the government was "not just talking, but acting."

Strong Political Party Still Encountered Conflict

While the stability of the PRI party in the executive branch allowed budgets to pass easily, it did not protect the party from internal dispute over the pace and direction of deficit reduction. The Mexican political system remained relatively cohesive for decades. Up to 1988, no one seriously challenged the PRI candidate in a presidential election, and the executive branch faced few political constraints in formulating or passing a budget from the legislative branch.

Conflict did take place, however. Former and current government officials described serious conflicts over the amount of cuts required of secretariats in the de la Madrid administration. Some government officials at the time believed that the budget must be in surplus to reduce inflation, and started to focus more on long-term, structural change. Others in the government felt that the pace of change was too fast and the cuts too great. The heads of some sub-secretariats balked at continued cuts in their budgets, and according to interviewees, two undersecretaries left the government. However, the President firmly supported continued deficit reduction.

High Deficits Left a Legacy of Unmet Needs

While the budget currently remains in a surplus and the economy is stable relative to the past decade, the Mexican government will face increased budgetary pressures for social and investment needs in the coming years. In addition to the specific items discussed below, Mexico, unlike the other case study countries, faces the serious challenge of raising the standard of living for its population. Partly for this reason, the government intends just to maintain a balance in the coming fiscal year, rather than remain in surplus.

Even before the social unrest in the southern Mexican state of Chiapas in early 1994, Salinas' government and the presidential candidates emphasized reducing the surplus by boosting spending in social programs. Interviewees suggested that the public, after a decade of austere public

sector budgets, might increase pressure to spend some of the benefits of the new-found fiscal health. Contrary to the experience of some other case study countries, according to a recent analysis,[6] it appears that all but the highest level of Mexican income earners were adversely affected by the inflation and deficit reduction policies of the 1980s. Capital mobility allowed those with substantial assets to avoid the pain (or even benefit) from the fiscal adjustment. Wage and salary earners in the middle deciles were hurt by the fall in real wages, and the rural poor who rely on income from agriculture suffered, because agricultural wage and nonwage income deteriorated substantially from 1986 on.

In addition, the government will have to address the depleted reserves of the national pension fund. Interviewees told us that the national pension fund surplus had been depleted in the 1980s to fund current government operations. A budget expert in Mexico was also concerned about public entities that are not controlled in the budget. According to the expert, these entities, such as the National University, while not large in number, do require a significant and growing amount of public funding.

The fiscal adjustment left Mexico with other unmet needs. Deferred capital maintenance will only result in deferred costs. Some analysts argue that the type of investments made during Mexico's 1970s boom years were not necessarily productive or economical, such as investments in petrochemical plants, which are highly capital intensive and require only skilled labor, when petrochemical products were available at low prices in world markets. Analysts argue that this type of spending did not address the country's employment needs. In addition, the investment cuts of the 1980s delayed important basic infrastructure maintenance. For example, as of 1992, only one third of Mexico's 265 sewerage plants were operating.

Conclusion

Mexico was forced to implement deficit reduction when it faced a severe economic crisis. When an initial, short-term effort to address the deficit and stabilize the economy was unsuccessful, the government adopted a more structural, long-term approach. The Mexican government eliminated its deficit by maintaining revenues while cutting spending. By working with affected groups, the government gained support for its efforts and gradually established credibility for its policies. Deficit reduction helped turn the circle of deficits, rising interest costs and expanding debt into a circle of fiscal surplus, shrinking debt, and increased fiscal flexibility. At

[6]Nora Lustig, Mexico, The Remaking of an Economy (Washington, D.C.: The Brookings Institution, 1992).

the conclusion of our work, Mexico maintained a surplus of approximately 1 percent of GDP.

United Kingdom

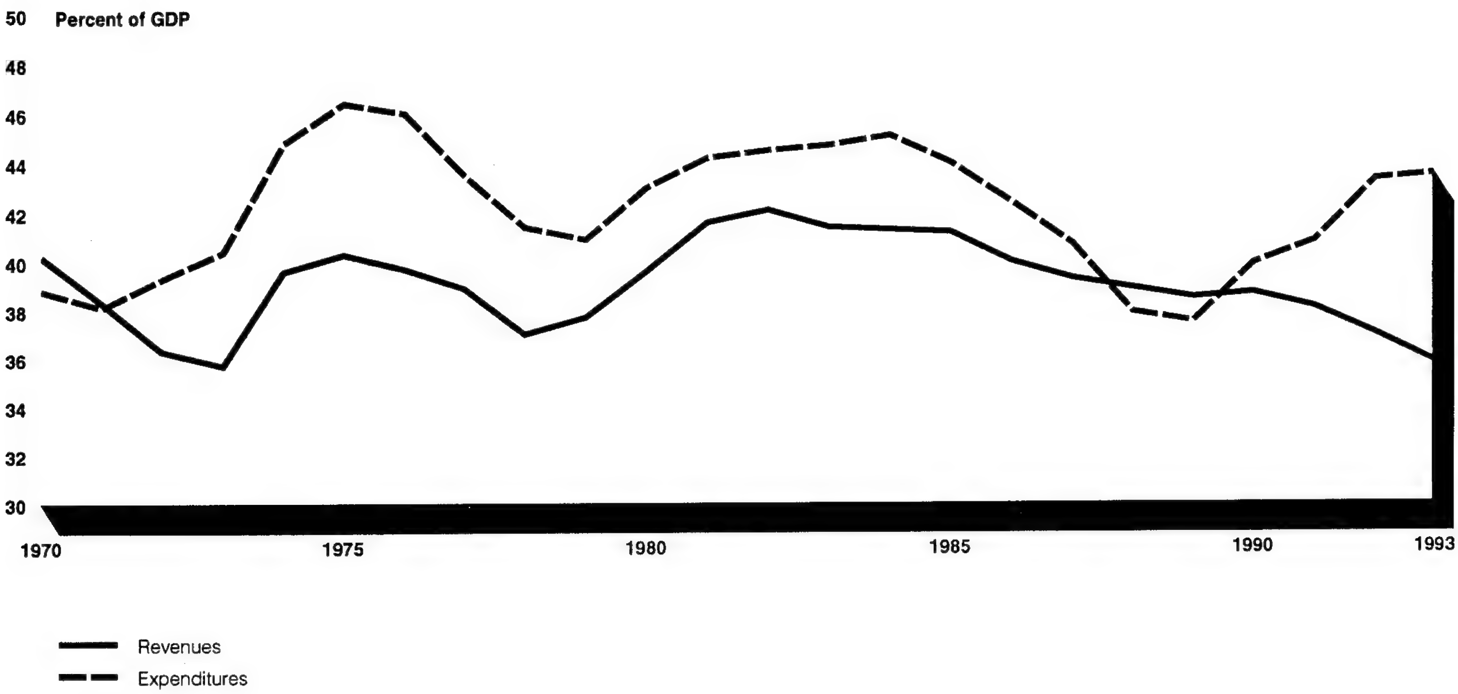
From a deficit of nearly 5 percent of gross domestic product (GDP) in the mid-1970s, the United Kingdom reached surplus in its general government financial balance by 1988.[1] Deficit reduction occurred primarily on the spending side of the budget but can be attributed to a variety of government actions and fortuitous economic circumstances. Government actions included expenditure restraint, tax reform, privatization, and the sale of North Sea oil. A sustained period of economic growth compounded the effects of these actions during the late 1980s. While public sector borrowing has risen again in the 1990s, the government is seeking ways to bring the budget back towards balance.

A budget process tightly controlled by the central government, strong parliamentary majorities, and limited interest group involvement gave the government substantial leverage to develop and carry out fiscal austerity policies. Nonetheless, officials sometimes had difficulty reaching agreement and at times had to reverse or modify proposals in response to strong opposition from within the government.

[1]The Organization for Economic Cooperation and Development (OECD) defines general government as all levels of government combined. For ease of comparability, this appendix relies primarily on OECD data. Where applicable, differences between national and OECD data or definitions are explained.

In addition, local government controls a relatively small portion of public sector revenue in the United Kingdom. Therefore, this appendix will focus on data for general government.

Figure VI.1: General Government Revenues and Expenditures in the United Kingdom, 1970-1993



Source: OECD Economic Outlook, #51 (1970-1977) and #55 (1978-1993).

Background

The United Kingdom is a unitary state composed of England, Scotland, Wales, and Northern Ireland. Local governments, called local authorities, are responsible mainly for education, housing, and social services. Local authorities account for around one quarter of all public expenditure in the United Kingdom, although a substantial percentage of this is financed by the central government.

The government is a parliamentary system, with a Parliament composed of two chambers—the House of Lords and the House of Commons. The House of Lords (approximately 1,200 members) is composed primarily of hereditary and life peers and has relatively limited powers. The House of Commons (651 members) is elected and is responsible for the passage of legislation and scrutiny of public administration. The government is headed by a Prime Minister, who is the leader of the majority party in the House of Commons, and an appointed Cabinet of around 20 members.

The Conservative party came to power in 1979 and has been re-elected three times since. For most of the time covered by this study, Margaret Thatcher was Prime Minister. Labor, the main opposition party, held 264 seats in Parliament to the Conservative party's 333 seats as of October 10, 1994.

The Budget Process

The governing political party effectively controls the entire budget process. Spending and tax decisions are made primarily within the Treasury and by its head, the Chancellor of the Exchequer. The governing party also controls fiscal policy through its influence over Parliament and its control of the central bank of England and local authorities.

The Treasury has controlled budget resources in two ways: through an overall spending target for total government spending and through cash limits for specific programs. The spending target covers the majority of the budget, excluding interest, privatization proceeds, and the cyclical portion of social security. The latter represents social security spending resulting from a downturn in the economy, such as increased unemployment compensation. Included in the spending totals is an amount set aside for a reserve fund controlled by the Treasury. The government attempts to stay within this overall target—if spending in one area grows faster than predicted, the government reduces spending in other areas.

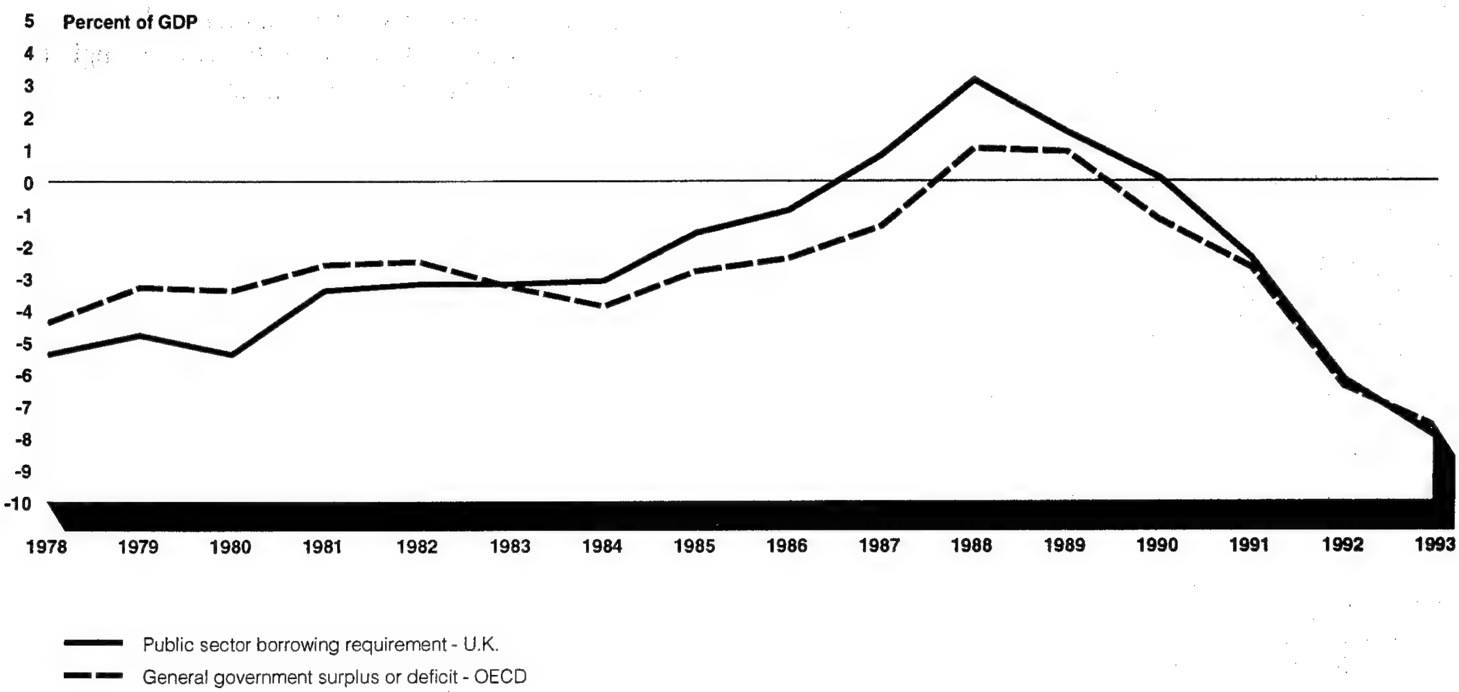
While the spending target applies to overall outlays, cash limits affect specific programs. Over the last 15 years, the government has expanded the number of programs under cash limits. If a program exceeds its cash limit for any noncyclical reason, including higher than expected inflation, the department must request and provide justification for additional funds from the Treasury reserve fund. Aside from the cash limits that affect spending for particular programs, cash limits on budget items, such as "running costs" (pay and administrative budgets), for both discretionary and entitlement programs are also set.

Deficit Measurement

In measuring its deficit, the United Kingdom focuses on the public sector borrowing requirement (PSBR), which includes receipts and expenditures at all levels of government, including borrowing by nationalized industries, debt interest, and privatization proceeds. However, fiscal goals are often presented both with and without privatization proceeds.

In principle, the measure used by the Organization for Economic Cooperation and Development (OECD)—general government financial balance—is also the difference between public sector receipts and outlays. Due to methodological differences, however, the two measures are not always the same. The basic trends, however, are similar, as seen in figure VI.2. This appendix relies primarily on OECD data.

Figure VI.2: OECD and United Kingdom Measures of Deficit/Surplus, 1978-1993



Note: PSBR is measured on a fiscal year basis. General government financial balance is measured on a calendar year basis.

Sources: OECD Economic Outlook, #55, and Bill Robinson, Social Market Foundation Report: Britain's Borrowing Problem (Surrey, England: The Social Market Foundation, 1993).

Impetus for Reducing the Deficit

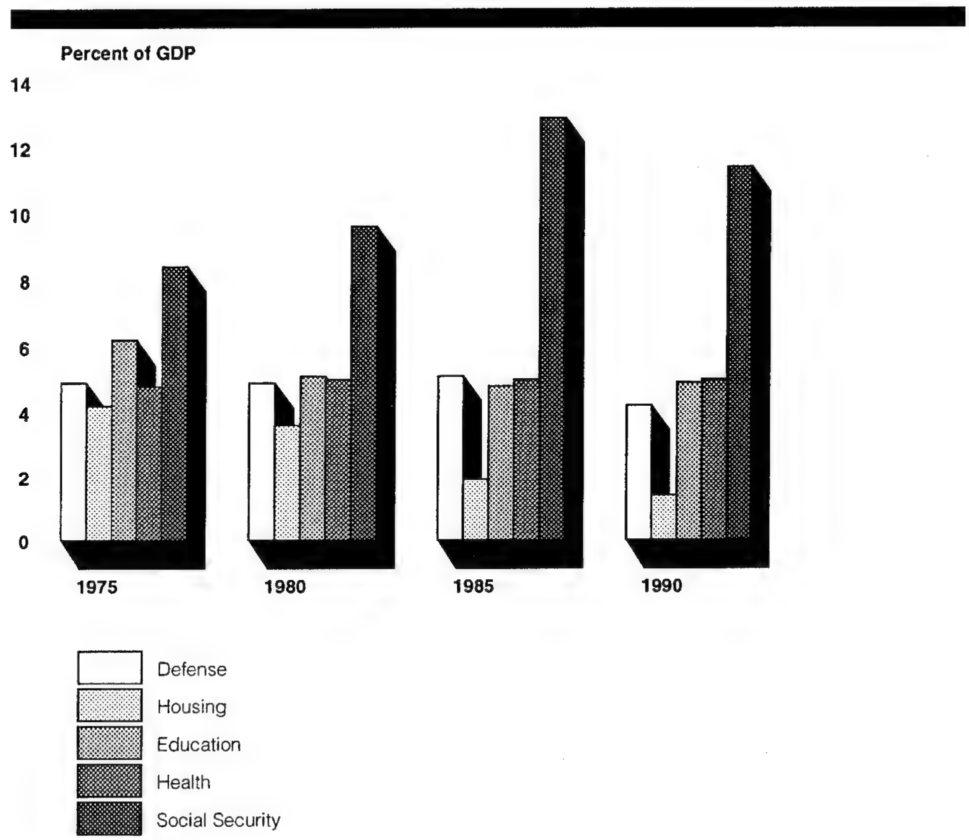
Although deficits grew steadily over time as a percent of GDP, they remained at relatively modest levels until the mid-1970s when expanding social welfare spending and deteriorating economic conditions worked together to drive up public sector borrowing. A currency crisis in the

spring of 1976 spurred efforts to tighten fiscal policy for a few years, but continuing economic problems brought back increasing deficits.

Social Spending Increases

Social reforms introduced in the 1960s and 1970s created a comprehensive social welfare system with graduated, noncontributory benefit programs and benefits indexed to offset the effects of inflation. Social security in the United Kingdom includes housing and child benefits; pensions; and income support for the unemployed, sick, disabled, and low-income and one-parent families. According to the United Kingdom's Department of Social Security, policy changes combined with demographic, economic, and social factors to drive up benefit costs, as shown in figure VI.3. Demographic factors included a larger number of elderly persons, higher unemployment, and an increasing number of single parents.

Figure VI.3: Selected Public Spending Components in the United Kingdom, Share of GDP 1975-1990



Source: Robinson, Social Market Foundation Report: Britain's Borrowing Problem.

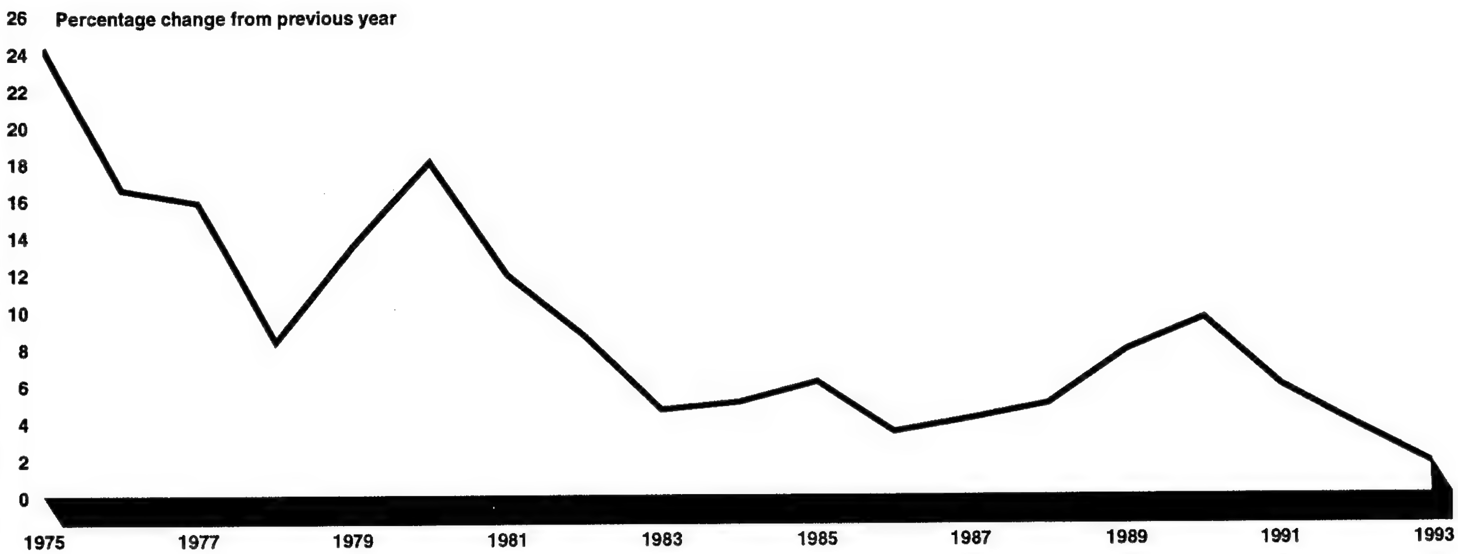
Social security spending was the fastest growing and the largest social component of the budget, rising from 5.1 percent of GDP in 1950 to almost 13 percent in 1985. While social spending as a whole increased, spending for housing declined dramatically due to government policies that scaled back public housing.

Deteriorating Economic Conditions

A series of oil price increases pushed inflation upward, first in 1973 and again in 1978 and 1979 (see figure VI.4). Unemployment, shown in figure VI.5, rose from around 2 percent in the early 1970s to over 5 percent in 1977, and the country experienced a recession in 1974 and 1975. These factors exacerbated public concern over the United Kingdom's economic

growth, seen in figure VI.6, which had been lagging behind other industrialized countries for some years.

Figure VI.4: Consumer Price Inflation in the United Kingdom, 1975-1993

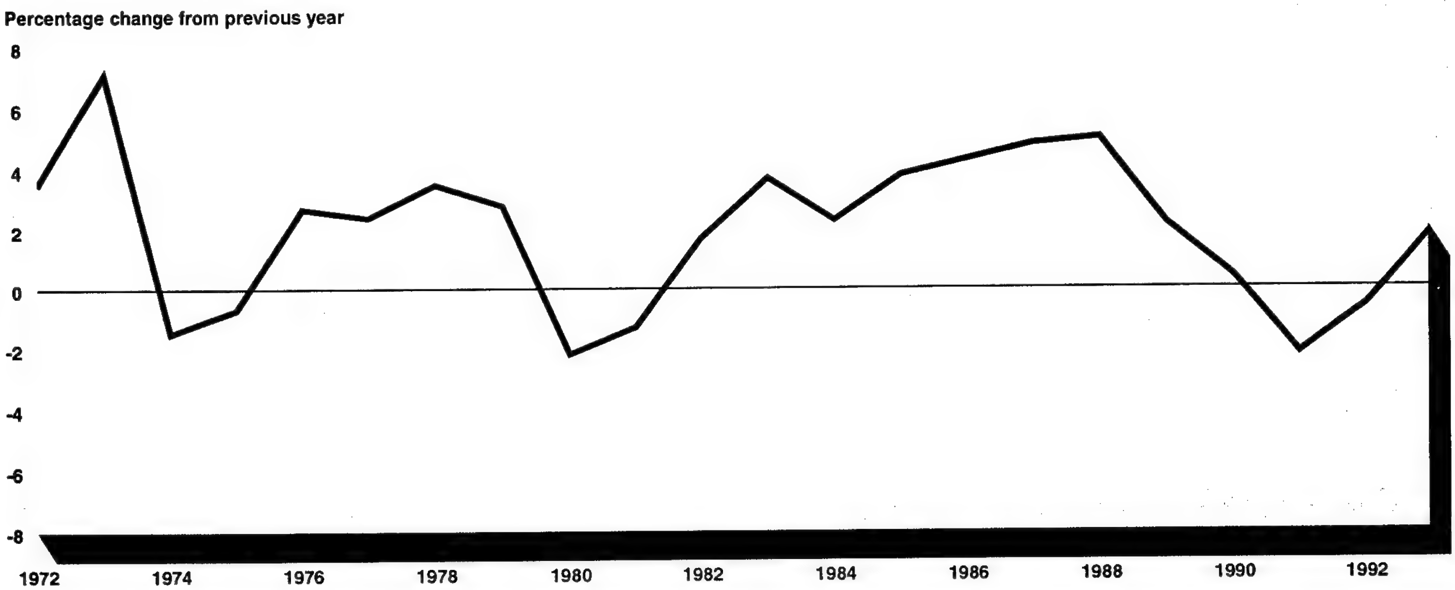


Source: OECD Economic Outlook, #55.

Figure VI.5: Unemployment Rate in the United Kingdom, 1972-1993

Source: OECD Economic Outlook, #51 (1972-1977) and #55 (1978-1993).

Figure VI.6: Real GDP Growth in the United Kingdom, 1972-1993



Source: OECD Economic Outlook, #51 (1972-1976), and #55 (1977-1993).

In 1974 and 1975, public expenditure climbed to nearly 50 percent of GDP, and the government ran the largest deficits of the postwar period. Fears of the deficit and economic instability contributed to a speculative currency run in 1976. The value of the pound stood at 1.93 against the dollar in May 1976, but dropped to 1.56 against the dollar by September of the same year. To secure the value of the pound, the government borrowed over £1.1 billion from the International Monetary Fund (IMF); deficit reduction was one condition for the loan. According to OECD data, the deficit fell to 3.2 percent of GDP in 1977. However, the government then loosened fiscal restraint and the deficit rose to 4.3 percent of GDP in 1978, despite an economic upturn.

Turning Point in Fiscal Policy

Although the previous Labor government took some deficit reduction actions, the election of the Conservative government in 1979 formed a significant turning point in fiscal policy. Treasury documents state that the

new government's medium-term economic objectives sought to bring down the rate of inflation and interest rates to create conditions for sustainable growth of output and employment. According to the Conservatives, this was to be done through control of the money supply, which was affected by the public sector deficits. The government supported the theory that the United Kingdom's economic problems and large deficits were interrelated and that very large deficits would lead to continuous economic distress. The Thatcher government made a commitment to pursue deficit reduction over a period of years, as stated in the 1980-1981 Budget:

"The consequence of the high level of public sector borrowing has been high nominal interest rates and greater financing problems for the private sector...If interest rates are to be brought down to acceptable levels, the PSBR must be substantially reduced as a proportion of GDP over the next few years."

Deficit Reduction Actions

Overall, deficit reduction during the 1980s was accomplished by constraining the growth of public expenditure. Although spending across government programs was held down, spending in certain areas was protected more than in others. Deficits were also reduced by the effects of privatization and oil sales, strong economic growth, and lower inflation, which reduced debt interest payments and indexation costs. Tax reform actions were generally revenue neutral, but some changes did generate additional revenue. Management and budget reforms also helped deficit reduction.

Real Growth in Total Spending Held to Low Levels

During the 1980s, annual real growth in total public expenditure averaged 1.3 percent—a significant drop from the 1970s level of 3.3 percent. Although the drop was substantial, the government made few major structural changes and did not eliminate programs to achieve this change; rather, existing programs were trimmed and modified in a decremental fashion.

These fiscal decisions were framed by targets that were set to control overall expenditure growth. Within the overall growth targets, programs could grow at different rates. For example, demand-led programs could grow faster. Social security spending increased at an average annual rate of 3.8 percent in real terms from fiscal years 1978-79 to 1992-93 while overall expenditures under the spending target increased only 3.1 percent.

Former officials and analysts told us that although the targets were not always met and that cuts were not necessarily done in the most efficient or lasting way, they served to help restrain overall spending growth.

Spending Actions

Savings came from many areas of government. In terms of programs, savings were achieved by cutting spending in the areas of transportation, trade and industry, and housing. According to the former Chancellor of the Exchequer, these areas were cut 5.8, 38.2, and 67.0 percent, respectively, in real terms between fiscal year 1979-80 and fiscal year 1989-90.[2] In addition to the spending cuts listed below, higher economic growth and a system of spending limits also contributed to overall savings. Privatization contributed to lower recorded spending levels by bringing in revenue which is included in the United Kingdom's budget as negative expenditures.[3]

Investment Cut Significantly

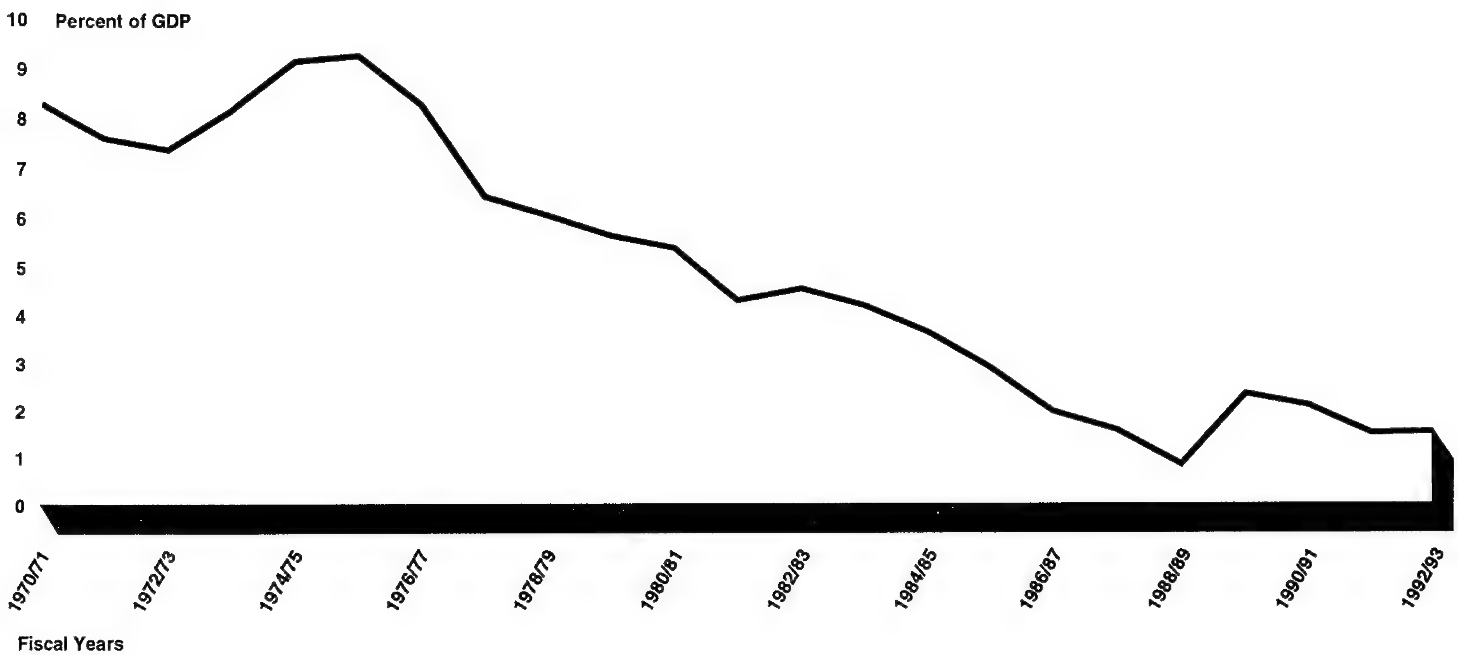
Like most other countries in this report, the United Kingdom cut investment spending significantly in the 1980s. Although some investment cuts involved delaying capital expenditure and improvements on public infrastructure, about half of the reduction relative to GDP was due to the withdrawal of the public sector from the housing market as part of its privatization efforts. The public sector had played a significant role in the provision of rental housing, but in order to promote home ownership, the government sold part of the public housing stock and reduced public housing construction considerably. A recent study suggests that the decline in the deficit as a percent of GDP in the 1980s was associated with a similar decline in net public sector capital spending.[4] Analysts told us that while spending on public infrastructure was easier to cut than current spending, capital spending increased after 1988 because improvements could not be delayed any longer. (See figure VI.7.)

[2]Nigel Lawson, The View From No. 11 (New York: Doubleday, 1993), p. 301.

[3]In some countries, privatization also contributes to deficit reduction by eliminating areas of spending in the budget, such as subsidies to national industries or investment. However, according to one analysis, spending on the nationalized industries which were the main targets of the privatization program was not counted officially as government expenditure. (Bill Robinson, Social Market Foundation Report: Britain's Borrowing Problem (Surrey, England: The Social Market Foundation, 1993), p. 27.)

[4]Nigel Pain, Garry Young, and Peter Westaway, "The State of the Public Finances," National Institute Economic Review (London: National Institute of Economic and Social Research, 1993), pps. 32-35.

Figure VI.7: Net Capital Spending in the United Kingdom, 1970-1993



Source: National Institute of Economic and Social Research.

Social Spending Growth Slowed in Late 1980s

Primarily economic growth, rather than government actions to reform the social welfare system, slowed social program spending. Economic growth can reduce the number of beneficiaries for social programs that react to economic cycles, such as unemployment. Although the government instituted numerous changes in social programs, spending cuts were limited in scope. Some of the beneficial effects of economic growth were offset by other factors, however. Pension spending rose rapidly throughout the 1980s from growth in the number of beneficiaries and the introduction of some new benefits.

The social security system in the United Kingdom includes a variety of social welfare programs in addition to pensions. The social security contributions, or National Insurance, go into a special fund for all contributory benefits. The fund is supported on a pay-as-you-go basis, with current contributions supporting retirees and other beneficiaries, although contributions do not always match benefits and at times must be supplemented by general funds. Contributions account for about one half

of the total funds required to finance social security programs, with general tax revenues supporting the rest.

Some examples of the policy actions the government took to reduce social spending are outlined below.

- Indexation of pensions and other social security benefits. The most significant social spending reduction came from the 1980 change in the formula for indexing basic pensions and other social security benefits. The revised indexation formula tied increases solely to price, rather than the greater of price or wage increases as was done previously. Since prices normally increase more slowly than wages over the long run, this change resulted in long-term budget savings. Although the year-to-year adjustments were small, the cumulative impact proved substantial. By 1988, the change meant, for example, an almost 20 percent lower pension for a married person, and it lowered government expenditures by £4 billion a year. One analysis suggests that political opposition to this change was muted both because of the technical and decremental nature of the change and the weakness of the pensioner lobby.[5]
- State Earnings-Related Pension Scheme (SERPS). The SERPS program provides a pension over and above the basic national pension with the additional amount based on an individual's earnings. SERPS benefits were scaled back in 1986 by reducing the level of the pension from 25 percent of the annual average of the highest 20 years' earnings to 20 percent of the annual average of an individual's lifetime earnings, with half rather than the whole pension passed to the surviving spouse. While the costs of the transition will not allow great savings in the short run, by 2021, SERPS expenditures are projected to drop more than 50 percent compared with pre-reform estimates.
- Single-Payment Social Fund. This program had allowed people receiving social security benefits to apply for a single cash payment to buy expensive items, such as washing machines. To check escalating program costs and widespread abuse, the system of single payments was replaced by a cash-limited Social Fund empowered to make loans to the poor in appropriate circumstances.

Public Sector Payroll Reduced

After fulfilling campaign promises to increase public sector wages, the government moved to reduce labor costs and increase productivity and efficiency. By 1986, the civil service payroll had fallen by almost 20 percent. According to OECD, by mid-1992 the public sector employed

[5]Paul Pierson, Dismantling the Welfare State? Reagan, Thatcher and the Politics of Retrenchment (Cambridge, United Kingdom: Cambridge University Press, 1994), p. 59.

4.9 million people, nearly 1.7 million (26 percent) less than in 1979.[6] This was accomplished by privatizing public industries and by mandating cost reduction in smaller agencies whose work could be contracted out.[7]

Local Authority Spending

Controlling local government expenditure addressed two of the government's policy objectives in the 1979 elections—reducing both the size of general government and the general government deficit, which includes local governments' financial balance. Local governments finance their spending through taxes, central government grants, and borrowing. A government official told us that in the early 1980s, the central government tried to moderate local spending by reducing central government grants. Although the ability of local governments to borrow was limited, local governments could increase spending by increasing tax rates. In response, the central government introduced a system of local tax rate caps. While the official felt that these mechanisms did not contribute in a significant way to deficit reduction, he said the mechanisms did slow the growth of local government expenditure.

The continuing difficulty of controlling local authority spending and the desire to tie local spending decisions to local tax rates led to a change in 1989 and 1990 in two sources of local financing: business and residential property taxes. The locally set business property tax was replaced by a centrally determined flat rate tax across all local authorities. The Community Charge, generally referred to as the "poll tax," replaced property taxes and was a flat rate tax on all adults. The tax was determined by each local authority, with certain rebates and limited exemptions. The tax was criticized by analysts because the overall impact of the new system of local government finance involved a movement in the tax burden from richer to poorer communities.

Moreover, the individual tax burden proved to be greatly underestimated—in 1988, the government envisaged a poll tax averaging £200 per person, but £400 was required by 1990. In 1991, the poll tax was replaced with a new Council Tax, based largely on property values. Interviewees said the end result of the poll tax policy was to increase central government transfers to local government, rather than reduce

[6] The public sector includes local government services, public corporations, the National Health Service, the armed service, and the civil service. The civil service accounts for about 10 percent of all public sector employees.

[7] The personnel and public wage reductions from privatization were separate from a large-scale management initiative implemented by the government in the latter half of the 1980s called "Next Steps." "Next Steps" involved delegating functions to newly formed separate executive agencies to be run more like businesses. Although it was related and likely saved money, the main purpose of the "Next Steps" initiative was to promote efficiency and "value for money" rather than reduce spending directly.

spending, since the central government provided substantial subsidies to local authorities to mitigate the effects of the poll tax. The subsidies were financed by an increase in the value added tax (VAT) from 15 percent to 17.5 percent.

Budget Process Reform

The government's switch from volume planning and budgeting to cash planning and limits was the main budget process reform of the last 20 years. Before the mid-1970s, the government had used what was termed "volume" planning to estimate expenditure. The future costs of programs were planned in volume terms. Interviewees described the system as one where budgets ended up being set in terms of the volume of goods needed by the program, such as the number of schools or number of books per student, without means of controlling overall costs. If inflation or other demands caused department budgets to increase, additional funds would be provided to cover the difference.

After the currency crisis of 1976, in an effort to better control spending, the government introduced its system of cash limits. While only some programs were under the cash limits system at first, the new Conservative government brought more programs under the system and then abandoned volume budgeting altogether. Under the cash planning system, outyear budgets take into consideration projected inflation. As mentioned earlier, if actual inflation is higher than projected, departments must seek and provide justification for additional funds from the reserve maintained by the Treasury.

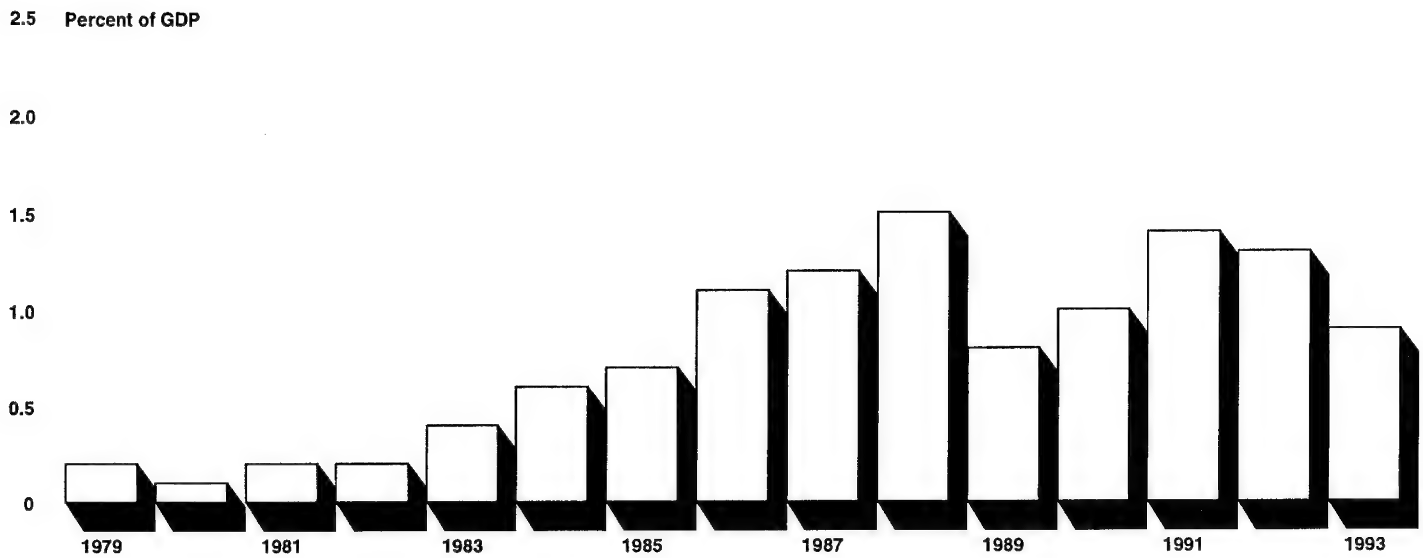
Privatization

The sale of public assets in the United Kingdom included privatization of both nationalized industries and public housing. The Conservative party supported privatization in its 1979 election manifesto, which outlined the party's main policy positions. Privatization was seen as a way to increase private sector involvement in the economy and to improve overall economic efficiency. According to a government official, the privatization effort was undertaken because it was in line with the political philosophy of the Conservative party and not necessarily to raise revenue. In addition, according to a Treasury document, the nationalized industries had a disappointing performance record. A number of nationalized industries recorded losses in the early 1980s.

The United Kingdom undertook privatization starting in 1979, with the sale of shares in British Petroleum. Between 1979 and the end of fiscal year 1993-1994, the government raised about £56 billion from the sale of

state-owned industries. (See figure VI.8.) Additional revenues were expected in the 1990s, but proceeds have been gradually decreasing.

Figure VI.8: Revenue From Privatization in the United Kingdom, 1979-1993



Source: HM Treasury (United Kingdom).

In addition to the one-time revenue gained by these sales, privatization also permanently reduced the public sector costs associated with supporting the industries. By the 1992 general election, approximately two thirds of the formerly state-owned industries had been transferred to the private sector, including industries in telecommunications, oil, gas, electric utilities, and aerospace. The sale of these nationalized industries, because of accounting conventions, count as negative spending rather than revenue, and serve to reduce total government expenditure. In its budgets, the government shows government spending both with and without privatization receipts from these industries. The privatization proceeds offset is not considered when the government establishes its spending objectives.

The sale of public housing, called council houses, also started in 1979. Beginning with the start of the Thatcher administration, local authorities were compelled to sell council housing on attractive terms to those tenants who wished to buy them. Not only did this lead to an increase in home ownership, but it raised revenue from £750 million in 1979 to over £5.5 billion in 1989. The sale of council housing also aided deficit reduction by saving money normally spent on building or maintaining public housing.

Revenue Actions

The government relied more on spending actions than direct tax actions to reduce the deficit. However, increased revenue from changes in the tax system, economic growth, privatizations, and oil revenue contributed to deficit reduction. According to OECD data, general government receipts increased at first, reaching approximately 42 percent of GDP in 1982, but then drifted slowly down to between 38 and 39 percent at the end of the decade.

Tax Reform

Tax reform played a mixed role in deficit reduction under the Conservative government. It was considered an important element of the Conservative government's economic growth strategy, and revenues from different sources increased at different times. Tax reforms were initially described as broadly revenue neutral and were designed to place more emphasis on consumption based taxes. The government increased the VAT but reduced tax rates on income, savings, and corporation profits. Other changes raised revenues. Lower tax allowances for some groups and the 1-year suspension of inflation indexation are two examples.

Government action over the 1980s affected revenue policy in the United Kingdom in three ways—through changes in tax rates, changes in corporation tax allowances that fostered an increase in corporation tax revenues, and changes in other tax allowances and indexation. Oil proceeds and economic growth in the late 1980s also helped maintain tax receipts.

VAT Rate Increased, Income Tax Rate Decreased

In 1979, the new government shifted the emphasis of the tax system from income taxes towards VAT. The government was committed to lower income tax rates, arguing that the change would reduce disincentives to work and save. The basic income tax rate was initially reduced from 33 percent to 30 percent in the fiscal year 1979-80 budget. In the second half of the 1980s, basic income tax rates were reduced further, in three steps—in the 1986-87, 1987-88, and 1988-89 budgets—from 30 percent to

25 percent, while the top rate was reduced from 98 percent (83 percent rate plus a 15 percent surcharge on investment income) to 40 percent. Revenue from income taxes drifted slightly down during this period, from between 10 and 11.5 percent of GDP in the first half of the 1980s, to between 9 and 10 percent of GDP in the latter half.

These changes were designed to be deficit neutral: the government raised the consumption tax rate to offset the income tax rate cut. The government increased two existing VAT rates, the standard 8 percent rate and the 12.5 percent rate on certain luxury goods, to a single 15 percent rate. The VAT rate was increased again to 17.5 percent in April 1991. Revenue from VAT taxes has more than doubled as a percent of GDP since fiscal year 1978-79, from 3.1 percent to 6.5 percent of GDP.

Table VI.1: Shifts in Public Sector Revenue Sources in the United Kingdom

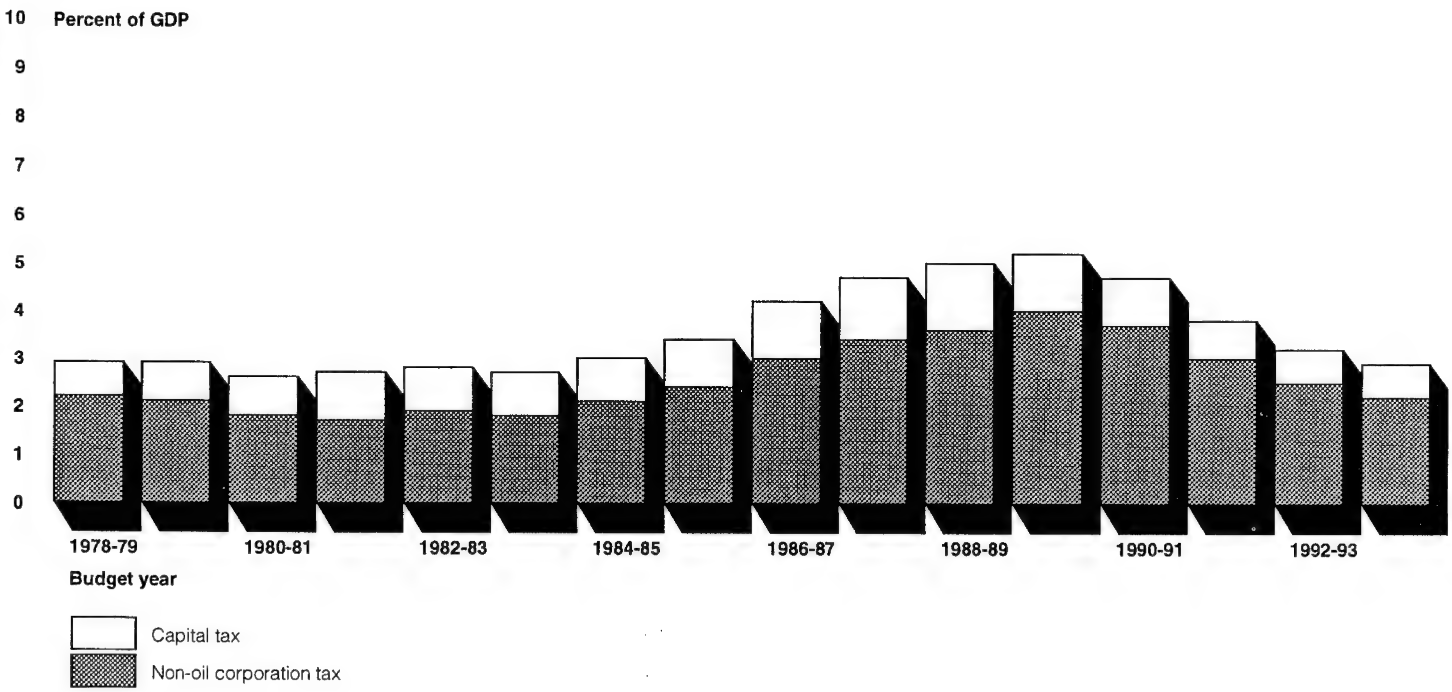
	Shares of total public sector revenue	
Public sector revenue source	**Fiscal year 1978-79**	**Fiscal year 1993-94**
Income tax and National Insurance contributions	45	43
Excise and local taxes	28	25
Non-tax and North Sea oil revenue	11	5
Non-oil corporation tax and capital tax	8	8
Value added tax (VAT)	8	18
Total	**100**	**100**

Note: Totals may not add due to rounding.

Multiple Factors Raised Corporation Tax Revenues in Mid-1980s

Revenue from corporation taxes increased significantly during the 1980s, as seen in figure VI.9. Analysts said this was due to both economic growth and a series of reforms adopted over the decade which focused on reducing distortions in the corporation tax system. The reforms included changes in corporation tax allowances and cuts in corporation tax rates. Tax allowance changes included raising taxes on capital gains and reducing the value of capital depreciation allowances. A 1-year write-off of plant and machinery was replaced by a new system that lengthened the write-off period. Because of the longer write-off period, the value of allowances fell sharply, producing a large—but temporary—increase in tax revenues.

Figure VI.9: Non-Oil Corporation and Capital Taxes in the United Kingdom, 1978-79 to 1993-94



Source: Robinson, Social Market Foundation Report: Britain's Borrowing Problem.

Reductions in the corporation tax rates also affected revenue levels. Between 1980 and 1988, the tax rate for small firms was cut from 40 percent to 25 percent. A cut in the standard corporation tax rate was adopted in 1984 and phased in over 4 years, reducing the rate from 50 percent to 35 percent. The rate was further reduced in 1990 to 34 percent and in 1991 to 33 percent. According to several sources, the rate cuts encouraged both domestic and international corporations to expand their operations in the United Kingdom, increasing both profits and tax receipts. One analysis suggests that the lower corporation rates created a temporary competition between industrialized countries over attracting corporation business, which generated high revenues in the United Kingdom until other countries cut their corporate rates.[8]

[8]Robinson, Social Market Foundation Report: Britain's Borrowing Problem, pps. 15-16.

Cyclical economic growth in the late 1980s also contributed to increased revenues. Between 1980 and 1989, the corporation tax share of GDP more than doubled from 2 percent to 4.1 percent, but then slowly declined as economic growth declined and the value of the tax allowances gradually climbed back to their pre-reform levels.

Changes in Other Tax Allowances and Indexation: Examples of "Wedge-Shaped" Savings

Although the savings are difficult to quantify because of multiple interactions, some long-term gains were achieved by instituting policies with "wedge-shaped" savings profiles: small at the beginning but increasing over time.

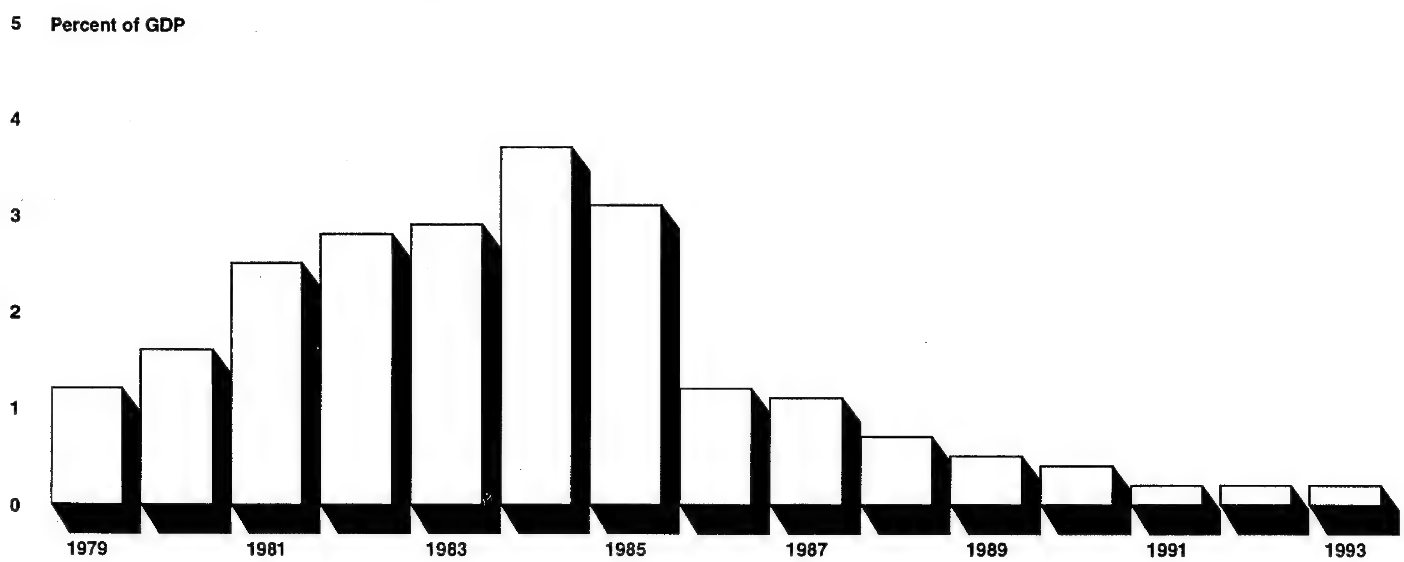
An official used the tax allowance on mortgage interest as a particular example. In the United Kingdom, the tax allowance on owner-occupied housing is based on the value of the mortgage and set in nominal terms, but not automatically indexed. The government last increased the allowance in 1983 but have held it at its 1983 level of a £30,000 mortgage. As housing prices increased during the mid- to late-1980s, the value of the allowance fell in real terms and represented a growing source of savings to the government. The value of the allowance was further decreased in 1988 by confining the tax allowance to £30,000 per residence rather than per mortgagor. Previously, several people could take the deduction for the same property. In 1988, the deduction for interest on home improvement loans was abolished.

Long-term revenue increases were also achieved by a 1-year suspension of the indexation of the tax system. Since the 1970s, the United Kingdom's statutory law has provided for indexation of the tax system to offset the effects of inflation. An amendment to the statute provided for indexation of personal allowances and a procedure for the government to seek parliamentary approval to override "automatic" indexation provisions in any given year. In practice, the government often takes advantage of the procedure to set indexation rates, both above or below that required by inflation. In 1980, personal income tax allowances were raised by 18 percent in line with inflation. But in 1981, the amendment was invoked to hold personal allowances and tax thresholds constant. With inflation above 11 percent, indexation was suspended to help hold down public sector borrowing. This action increased 1982 total tax revenues by almost £2 billion and lowered the base on which future tax adjustments would be made. In other years (1982, 1984, and 1985), the government chose to raise personal allowances more than what was required by the inflation indexation provisions. Other specific tax allowances, such as the capital allowance for corporations, are not automatically indexed.

North Sea Oil Provided Revenue

During the 1980s, North Sea oil was a significant source of public sector revenue through both taxes and royalties. At its peak in 1984, North Sea oil proceeds were more than 3 percent of GDP, representing almost 8.5 percent of total tax revenues. Between 1975 and 1981, the United Kingdom moved from a net importer to a net exporter of crude oil, but since the mid-1980s, oil revenues have been gradually diminishing due to lower oil prices and production. As seen in figure VI.10, North Sea oil provided substantial revenue over the 1980s.

Figure VI.10: Revenues From North Sea Oil, 1979-93



Source: Robinson, Social Market Foundation Report: Britain's Borrowing Problem.

Reaching Agreement

The Conservative government tied its deficit reduction policies to its overall economic policy when campaigning for office in 1979. Thanks to a large parliamentary majority after the election and the nature of the budget process, the government did not have to seek acceptance of its economic policies to the extent necessary in other case study countries. However, acceptance of austerity measures was not automatic, and at times, the government had to make concessions or reverse proposed policies. According to former and current government officials, the government at times tried to institute policies in a way that minimized

public opposition. Public commitments to reduce the deficit helped the government by putting pressure on Ministers to stay within stated budget targets.

Deficit Reduction Linked to Overall Economic Policy

The task of promoting deficit reduction took place more during the 1979 election than after. Deficit reduction constituted an important element of the Conservative party's economic policy election platform. The government proposed using a combination of monetary and fiscal policies which it felt would bring down inflation, reduce interest rates, and create conditions for a sustainable growth of output and employment. The key to the government's policies involved controlling the money supply. The government reasoned that deficits affected the money supply and, therefore, to control the money supply, the country needed to control its deficits. In this way, the government presented deficit reduction as a necessary tool to improve the economy. Moreover, the government stated that it could not reduce unemployment and sustain economic growth until inflation was brought under control. In addition, deficit reduction served as a tool to reduce the role of government in the economy, a fundamental Conservative party goal.

In the 1979 election, the Conservative party capitalized on public concern that poor economic conditions would lead to a further financial crisis and promised to set an entirely new course that would bring economic gains. At first, the government's goal was to reduce the deficit, but the government later redirected its strategy to maintaining a balanced budget over the medium term. According to one former government official, the Conservative party took "strong action and made a virtue of it."

Deficit Reduction Difficult Despite Strong Parliamentary Majorities

The government's ability to impose fiscal sacrifice was strengthened in the early 1980s by a large Conservative party majority in the House of Commons. For example, after the May 1979 election, the Conservative party used its strong political position to gain support for controversial tax initiatives, despite rising unemployment, strikes by miners, and general unrest in the country's labor market. Later, in the middle of a deep recession in 1981, plans were announced for controlling public expenditure by suspending tax indexation for 1 year, effectively raising taxes. The government continued with the plans in the face of strong public opposition. In March of that year, 364 of the country's leading economists signed a letter to The Times (London) newspaper deploring

the policies being pursued and predicting dire consequences if they were continued.

Despite the Conservatives' large majorities, achieving consensus within the government on some proposals was still difficult. The government had to make significant concessions and reversals throughout its tenure, and sought to minimize potential opposition by phasing in certain measures. An early example of a concession often cited in interviews was a campaign commitment in the 1979 election to adhere to the public sector wage increase recommendations of an independent commission. In another example, a proposal to increase the gasoline tax in the 1981 budget met with considerable discontent by members of the Cabinet opposed to strong fiscal measures—informally called "the wets." Their counterparts, "the drys," compromised by agreeing to confine the duty increase to one specific type of fuel indexed to the increase in inflation and to increase the tobacco duty as an offset to this.

The government engaged in more trade-offs at the end of the 1980s. For example, subsidies to local authorities were increased to deflect opposition to the poll tax. In the last few years, as part of efforts to extend the VAT tax to domestic fuel, the government promised offsetting compensation for all pensioners and for families receiving social benefits.

While a number of interest groups existed and met with party leaders, their ability to influence spending and tax decisions was limited due to the secrecy of budget decision-making and the political strength of the Conservative party during the 1980s. Traditionally, the strongest interest group in the United Kingdom has been the trade unions. However, the Conservative party believed in limiting the power of the unions, and through the 1980s, union power and membership declined.

However, public pressure forced the government to sometimes reverse or change its proposals. For example, by the 1980s, the earnings-related pension, SERPS, promised to substantially increase public spending. Although initially opposed to any changes in the program, in 1985, the Conservative government proposed to abolish SERPS over a lengthy transition period, promoting private sector earnings-related pensions instead. Due to heavy opposition from interest groups and concerns within the Conservative party, the government reversed its decision, but still lowered benefits, as described above, while continuing to encourage private sector alternatives. In addition to policy reversals, the government protected certain sectors from budget cuts. Health, education, and some

social program spending, including middle class benefits such as student grants and child benefits, was generally preserved.

The government enacted some changes in a way that provoked little opposition but which produced significant future budgetary savings. This strategy was particularly important when cutting benefits that have been, in effect, capitalized in the value of property or in expectations of future retirement support. For example, the change in the indexation base of pension benefits from wage growth to price growth was done at a time when wages and prices were growing at the same rate. But when prices fell behind wages, the government benefited from the lower index rate. The limit on the mortgage interest deduction, discussed earlier, is another example. The limit was placed on the deduction in the early 1970s, at a time when most mortgages were under the limit. Except for a 1-year increase in the limit in 1983, the government continued the nominal limit on mortgage interest deductions. Because the ceiling was not indexed, inflation has now made the ceiling an effective cap on the deduction, without any subsequent action on the part of policymakers.

Public Commitments

Policy documents which stated the government's long-term goals were used as mechanisms to strengthen the deficit reduction commitment and to maintain momentum for difficult policies during downturns, such as during the unexpectedly severe recession in the early 1980s. Although it was sometimes forced to make concessions or reverse proposals, by stating its intention to pursue deficit reduction and adhere to its spending targets, the government raised the political cost of policy reversals and put pressure on Cabinet ministers to stay within the agreed-upon targets. A former official attributed success in reducing deficits to maintaining deficit reduction "year-in and year-out," even during the 1980-81 recession.

Budget Deficits During the 1990s

In the late 1980s, the United Kingdom's economy seemed so much improved that the public began talking about an economic "miracle." The idea emerged that the character of the economy had been changed from business cycles of "booms and busts" to a longer-term pattern of economic growth. Some analysts argue that, as a result, the government loosened fiscal constraints with the expectation that economic growth would continue, providing increasing revenue to finance fiscal expansion. However, the economy entered its longest recession in postwar history in 1990. Public sector borrowing increased rapidly, and public finances are

once again a central economic problem facing the United Kingdom. The deficit reached 8 percent of GDP in 1993 according to OECD.

A recent study[9] of the current deficit situation in the United Kingdom outlined four main reasons for the rapid deterioration in public finances: increases in discretionary spending prior to an election, such as an increase in the Child Benefit; an economic recession; a decrease in tax receipts due to changes in the tax system; and rising debt interest costs. The government has renewed deficit reduction efforts, including strong restrictions on public sector pay and spending reductions in defense, housing, and transportation, to meet a medium-term goal of approximate balance by fiscal year 1998-99.

Conclusion

The 1979 election of a new government in the United Kingdom served as the major turning point in fiscal policy. The government, which had campaigned on a platform including deficit reduction, eliminated the deficit by 1988 by constraining the growth of spending. The government's efforts were helped by revenues from privatization, North Sea oil sales, and a sustained period of economic growth. A large parliamentary majority gave the government greater leverage in implementing its policies, but officials nonetheless had to reverse or modify some proposals due to internal and external opposition. Despite success in the 1980s, the government could not sustain its surplus; due to increased discretionary spending and a recession, the United Kingdom experienced a deficit of 8 percent of GDP in 1993.

[9]Robinson, Social Market Foundation Report: Britain's Borrowing Problem, p. 10.

Major Contributors to This Report

Accounting and Information Management Division Washington, D.C.

Barbara D. Bovbjerg, Assistant Director, (202) 512-5491
Thomas M. James, Evaluator-in-Charge
Maureen M. Berner, Evaluator
Hannah R. Laufe, Evaluator

Office of the Chief Economist

Richard S. Krashevski, Senior Economist

European Office

Patricia M. Riggle, Site Senior
B. Patrick Hickey, Evaluator